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1988 TAX RETURN FILING SEASON

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

FEBRUARY 23, 1988

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CONTENTS

Page

Press release of Thursday, February 4, 1988, announcing the hearing 1

WITNESSES

U.S. Department of the Treasury, Internal Revenue Service, Hon. Lawrence B. Gibbs, Jr., Commissioner of Internal Revenue; Michael J. Murphy, Senior Deputy Commissioner; William Nelson, General Counsel; and Dan Capozzoli, Assistant Commissioner for Computer Services..... 7

U.S. General Accounting Office:

Jennie S. Stathis, Associate Director, General Government Division 59

James R. Watts, Associate Director, Information Management and Technology Division..... 68

SUBMISSION FOR THE RECORD

John E. Shriver & Co., Philip L. Shriver, letter and attachments..... 119

APPENDIXES

A. Questions submitted to the Internal Revenue Service and their responses.... 90

B. U.S. Department of the Treasury, Internal Revenue Service, "1988 Filing Period Readiness Group Final Report," November 25, 1987 107

1988 TAX RETURN FILING SEASON

TUESDAY, FEBRUARY 23, 1988

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:34 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

THE HONORABLE J.J. PICKLE (D., TEXAS), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, ANNOUNCES A HEARING ON THE 1988 TAX RETURN FILING SEASON

The Honorable J.J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will conduct a hearing on the Internal Revenue Service (IRS) and the current 1988 tax return filing season. Specifically, the Subcommittee will review the quality and availability of IRS taxpayer assistance, with a focus on any taxpayer difficulties which have surfaced, including problems resulting from implementation of the Tax Reform Act of 1986; the preparedness of the IRS for the current filing season, including employee training, IRS contingency plans, and the availability of tax forms and publications; and, the status of Service Center workload inventories, including correspondence and adjustments, unpostables, returns processed and refunds issued. In addition, the Subcommittee will review the availability, utilization and capacity of computer equipment, including the status of the Communications Replacement System, electronic tax return filing, and development of the overall Tax System Redesign plan. The hearing has been scheduled for Tuesday, February 23, 1988, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m.

The Subcommittee will receive testimony from IRS Commissioner Lawrence B. Gibbs, Jr. He will be accompanied by the IRS Taxpayer Ombudsman and the Assistant Commissioners for Taxpayer Service and Returns Processing, Inspection, Computer Services, and Information Systems Development. In addition, the General Accounting Office will report on its continuing investigations of IRS operations, being conducted at the Subcommittee's request, including the replacement of the IRS' communications processors, efforts to extend the useful life of the IRS' mainframe computers, and the Tax System Redesign project. Witnesses representing tax professional organizations and tax practitioners will be invited to present testimony.

In announcing the hearing, Chairman Pickle made the following statement: "As a result of the sweeping tax changes contained in the Tax Reform Act of 1986, the Internal Revenue Service is facing its stiffest challenge in decades. In the next few months the IRS will be tested as never before. All America will be watching. And so I ask: Is the IRS prepared to meet this challenge? What can the Internal Revenue Service and the Congress do to insure that taxpayers have the information and assistance they need to properly file their tax returns?"

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS

Persons wishing to submit written comments for the printed record of the hearing should submit six (6) copies by the close of business, Friday, March 18, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of

Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515.

Chairman PICKLE. Good morning. The subcommittee will please come to order. I would ask our guests to take their seats.

Commissioner Gibbs, if you will come forward, I want to ask you a preliminary question prior to the beginning of the hearing today.

Commissioner, at our last subcommittee hearing in October of last fall, you testified that 5 of the well-known evangelistic organizations and 30 lesser known evangelists were in various stages of examination.

What do you have to report today respecting our hearings in October? Can you give me a report to update me on the status of these examinations?

Mr. GIBBS. Mr. Chairman, good morning.

Last October, as you indicated, I did testify that we had examinations underway involving 35 evangelistic organizations and individuals.

In information that we provided to this subcommittee, we indicated that we were in the midst of audits of those organizations, some of which were well-known, and some of which were not. As we noted, some of the issues that frequently arise and have been arising in these audits include the issue of personal inurement, unrelated business income, and political activities.

While we have not provided this subcommittee with additional information since our letter of November 16, 1987, we are in the process of implementing a new system of regularly obtaining information from the field on our enforcement activities in this area. Our examination efforts are conducted and controlled within the appropriate district offices and, therefore, we previously did not have a procedure at the national level to accumulate this kind of information for the subcommittee, but we will be doing so on a quarterly basis.

A letter that has been prepared and is in final review that I anticipate providing you with later on this week will give you an update. We will also have a letter that can be disclosed to the public with respect to our activities.

Chairman PICKLE. I'm glad to hear that.

The purpose of the question was to find out when we would get that report because we had asked for quarterly reports. And you expect one probably would be out by the end of this week?

Mr. GIBBS. That is correct.

Chairman PICKLE. Can you tell me if any of the audits have been concluded?

Mr. GIBBS. I have not seen the information at the present time, but we will have that and be able to provide that information to you.

I'm constricted to discuss the details of the audit, but I can report to you because it is in the public domain that, with respect to PTL, we have been very aggressively pursuing the tax that we feel is due. There are court hearings in process that are being reported. That is at least an indication of the type of action that we are taking in this area.

Chairman PICKLE. We look forward to your report because we want to be kept abreast of the status of the various examinations.

I thank you.

Mr. GIBBS. Thank you.

Chairman PICKLE. Now, Commissioner, since you are at the table, are you going to have any of the other individuals with you? You may bring them to the table now. I want to make a preliminary statement and then we will get right into this hearing.

Mr. GIBBS. Would you like us to testify first?

Chairman PICKLE. Yes. Would you prefer that?

Mr. GIBBS. That would be fine.

Chairman PICKLE. Let me also say at the beginning to you, Commissioner, that I understand this is your 25th wedding anniversary today. We are glad to know that.

Is there anything deductible about that in the taxes or anything? [Laughter.]

Do you claim any dependents?

Mr. GIBBS. There are benefits to 25 years of marriage but they don't fall in the tax area. [Laughter.]

Chairman PICKLE. Well, we're glad to know that. We wish you well.

I welcome the distinguished witnesses and visitors who are with us this morning at the Subcommittee on Oversight as it begins its review of the Internal Revenue Service's plans for 1988. Today we will be discussing two major questions. First, how well is the service meeting the challenges of the 1988 tax filing season? Second, how well are they planning to meet the challenges of the future by improving computer operations and redesigning the current system?

Everybody in America knows that this is our first year of operation under the new Tax Reform Act. That makes this an especially critical time for all of us who are responsible for the Federal tax system. Over the next few months, millions of taxpayers will be putting this landmark tax legislation to the acid test. It is our challenge to see that these reforms get the high marks I believe they deserve.

While the Tax Reform Act will have significantly different effects on different kinds of taxpayers, there is one common experience that we will all share. Each and every one of us, rich or poor, old or young, farmer or city dweller, will all experience a major change in the way we calculate our taxes. It is this change which presents the service with its greatest challenge. Not only must the IRS itself cope with the change, it must also help the taxpaying public through this period of adjustment.

Now, based on the investigations by the committee staff, by the U.S. General Accounting Office, and on the IRS' own reports, it is clear that an enormous effort has gone into preparing for this year's filing season. This effort is commendable, and I hope it means that the 1988 filing season will be as successful as those of the past 2 years.

I might say, Commissioner, that I'm particularly pleased that you're putting such emphasis on taxpayer service. It is not only time in the normal course of operation, but especially timely because of the change in the Tax Code. So I commend the IRS for your overall planning in this particular area.

However, while I hope for the best, I am seriously troubled by several trends that have already emerged this year. First, there appears to be a marked decline in the accuracy of taxpayer assistance the IRS provides with its toll-free telephone service. Early surveys, both public and private, indicate that the IRS is giving full and accurate responses less than 60 percent of the time. Second, there have already been problems with the availability and accuracy of a variety of taxpayer forms and publications. These trends left unaddressed will have a very serious negative impact on public confidence in tax reform and in our whole income tax system. It will increase the workload for both taxpayers and tax administrators alike, and no one, of course, will be the winner.

Looking beyond the difficulties of the next few months, we must not lose sight of the major challenges that the IRS must meet over the next decade in redesigning and upgrading its outdated computer operations. Unlike the situation in 1985, this is not an immediate crisis, and for this we should all be profoundly grateful. But the clear lesson of the past few years is that redesigning and replacing the Service's existing computers requires careful advance planning, and about twice as much time as you first think it will take.

I believe we are in a race to see if we can replace our current tax processing system before it is absolutely obsolete. Based on current estimates, it looks like it will be a close call over the next few years.

These are critical issues, and this morning we will be interested in hearing your statement and your plans at the Internal Revenue Service and how you're handling them.

Before we proceed, let me ask Mr. Schulze if he wants to make a preliminary statement.

Mr. SCHULZE. Mr. Chairman, I thank you, and I join you in opening the first and perhaps the most important Oversight Subcommittee hearing of 1988.

This year the subcommittee should maintain the momentum we developed last year on important issues. We need to follow through on our activities concerning the unrelated business income tax, pensions, excise taxes, and tax penalties.

I'm gratified to know that our findings and recommendations have been well received by the rest of the Congress. For example, our recommendations to improve the financial soundness of defined benefit pension plans were included in the Omnibus Budget Reconciliation Act of 1987. In addition, our subcommittee's recommendations for improving the Caribbean Basin initiative are the center of attention in the legislation before the Trade Subcommittee.

Therefore, Mr. Chairman, the subcommittee should be encouraged to develop thoughtful recommendations on other subjects in 1988.

Today's hearing will focus on the 1988 tax filing season. In earlier years, the subject of today's hearings would have been a fairly routine administrative exercise, but not this year.

1988 is the first year in which individuals will experience the full effect of the Tax Reform Act of 1986. Their first exposure to tax reform was the need to file the new W-4 form in 1987. The W-4 exercise was not a rousing success.

Therefore, the current tax filing season contains both hope and anxiety. The hope was that tax reform would bring a simple efficient tax system. But it has brought us something very different. It has brought us changes in 162 existing IRS forms, 48 brand new IRS forms, and 13 new IRS publications. Fourteen forms have not even received final approval, and it is almost February 23. Finally, tax reform will result in almost 4 million more tax returns being filed in 1988 versus 1987.

This realization leads to a lurking sense of anxiety that something could go wrong. The taxpayers may not start to fill out returns early enough. Taxpayers may not be able to get proper forms in a timely manner. The IRS may not be able to respond to a flood of requests for assistance. And when the IRS does respond to the taxpayers' questions, the GAO says the IRS is correct only 61 percent of the time. The 1988 filing season could become an unhappy stressful event which sours public opinion on tax reform and, just as importantly, on tax compliance. The dream of tax reform could turn into a nightmare.

It is encouraging that Commissioner Gibbs has made a strong effort to prepare his agency to implement tax reform as smoothly as possible. Today, the Commissioner can review the steps he has taken to prepare the IRS to implement tax reform. Even more significantly, he may be able to give us an early assessment as to the success of the 1988 filing season. He can hopefully reassure us that his agency is well prepared to implement tax reform and that the public is adjusting to it with a reasonable amount of effort.

One issue which we followed closely last year was the IRS computer operations. This included both the trouble plagued procurement of front-end processors and the long-range plan to upgrade the systemwide computer capability of the IRS. The recent indications are that the front-end processor procurement is under control. In addition, the long-range tax system redesign effort apparently has made good progress. Today, the Commissioner may be able to give us an authoritative progress report on IRS computer operations. An efficient, smoothly-operating computer network is an important element in improving taxpayer service.

Larry, I have the highest admiration for your ability to administer the tax law. If anyone can implement tax reform, that person is you. The problem is that Congress may have passed such sweeping tax changes that no Commissioner could implement tax reform.

Mr. Chairman, I join you in welcoming Commissioner Gibbs and the other witnesses and look forward to receiving their testimony.

Chairman PICKLE. Thank you, Mr. Schulze.

Before recognizing the Commissioner, do any other members want to make preliminary statements?

Mr. Archer, we're glad to have you with us.

Mr. ARCHER. Thank you, Mr. Chairman. I appreciate your indulgence in permitting me to sit in on the subcommittee's hearings. I want to compliment the chairman on this hearing, which is primarily devoted to the issue of the IRS' ability to administer the Internal Revenue Code in light of the changes in the 1986 Reform Act.

But I believe it's also extremely important that we consider the complexities and the difficulties that are being faced by individual

taxpayers in this country, as well as business taxpayers. I would urge the chairman to hold further, more extensive hearings in the future where both individuals and tax preparers can come in to shed light on the difficulties that they face with the massive changes made by the 1986 act which are causing significant anxiety and confusion amongst taxpayers. I'm afraid we're going to have even a louder cry when April the 15th approaches.

The concerns are being raised not only about the changes themselves brought on by the 1986 act, but also the complicated new forms and the instructions issued by the IRS and which Congress has mandated that they ensure compliance. The staggering nature of these changes can be seen in some of the statistics that our colleague, Dick Schulze, just mentioned. But in addition there are others; we should note that there were 2,704 changes in the Internal Revenue Code as a result of the 1986 Tax Simplification Act, as it has been called by some.

There has been an issuance of 42 IRS regulations, 65 IRS announcements, and 32 IRS revenue rulings. The issue of complexity, however, is showing up most clearly in the level of complaints which each of us is hearing from individual taxpayers about the forms and the instructions with which they must deal. It is particularly troubling and difficult to explain to such taxpayers, in light of the often repeated claims, that the 1986 act was a tax simplification act.

I opposed that bill, and I opposed it for many reasons. One of the reasons being that it created more complexities in the code than simplification. It flew under a false flag. The areas of particular concern to taxpayers as they struggle to cope with the 1988 filing season are interest deductibility. It's going to require tremendously precise recordkeeping for individual taxpayers and that is going to be extremely difficult.

The treatment of the investment income of minor children, employee business expenses, and the passive income and loss rules are complicated. I understand that the IRS has just issued its regulations, over 250 pages of regulations, on the passive loss rules, which are virtually impossible for the average taxpayer to understand. The treatment of sole proprietorships and the sale and exchanges of residences are examples of more complexity.

In each case, it is not only the forms, but also the worksheets and the instructions that taxpayers are finding both complicated and incomprehensible.

American businesses, small and large, are finding it extremely difficult to cope. One of the biggest companies in this country is finding that even with all its computer facilities that it cannot handle the demands put upon the computer in order to try to comply with this new code.

It's my hope that the subcommittee's work will involve an examination of both the broad and specific issues of the Internal Revenue Code's complexity which are generating concern throughout the Nation's homes and offices. Hearings of this nature provide input from the people who have to deal with it, individual and business taxpayers, and I think, would be extremely helpful to us, Mr. Chairman, in trying to find a way to have more simple implemen-

tation. It would permit the IRS to have an easier job rather than have to deal with the complexities in this 1986 law.

I thank the chairman.

Chairman PICKLE. Well, we thank you, Mr. Archer, and we appreciate your views.

Our purpose this morning is to see how the IRS is actually handling this filing season, how they're operating, and what their concerns are. And, Mr. Commissioner, we will be pleased to hear from you now at this point.

Now, I notice, Mr. Commissioner, you have a prepared statement here and it's indexed. Do you wish to follow this, or do you want to revise and extend and——

Mr. GIBBS. Mr. Chairman, I will follow it but I am not going to follow it in detail. I will tell you in my oral remarks where I am so that you can follow along.

Chairman PICKLE. If you'll do that, that will be helpful to us.

Mr. GIBBS. By referring to the page number, I will keep you posted as to where I am in my oral presentation this morning.

Chairman PICKLE. That will be fine.

If you'll proceed, and we are glad to have you here this morning.

STATEMENT OF HON. LAWRENCE B. GIBBS, JR., COMMISSIONER OF INTERNAL REVENUE, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY MICHAEL J. MURPHY, SENIOR DEPUTY COMMISSIONER; WILLIAM NELSON, GENERAL COUNSEL; AND DAN CAPOZZOLI, ASSISTANT COMMISSIONER FOR COMPUTER SERVICES, INTERNAL REVENUE SERVICE

Mr. GIBBS. Thank you. I would like to begin by introducing the Internal Revenue Service officials who are with me this morning. To my left and your right is Senior Deputy Commissioner Michael Murphy, and to my right, your left, our Chief Counsel, Will Nelson.

Also, as you requested, we do have behind me our Taxpayer Ombudsman, Damon Holmes, and we have four Assistant Commissioners, Ed Pecorella, who is the Assistant Commissioner for Taxpayer Service and Returns Processing; Ken Thompson, the Acting Assistant Commissioner, Inspection; Dan Capozzoli, the Assistant Commissioner for Computer Services, and, finally, Hank Philcox, our Assistant Commissioner, Information Systems Development.

Chairman PICKLE. We are pleased to have all of you here.

Mr. GIBBS. As you indicated, Mr. Chairman, I would like to ask that the written testimony be entered in the record and, as I indicated, I will summarize that testimony and keep you posted as to where I am.

Today I would really like to cover three subjects as the subcommittee has requested.

First, I'd like to present an overview of our efforts to carry out tax reform. Second, I'd like to give you a status report on the progress of this filing season. And third and finally, I'd like to provide our plans for the redesign of our tax system in order that we may be able to meet the demands of tax administration in the future.

The first subject therefore that I will cover is our planning for tax reform implementation. And I'm going to start on page 1 of the written testimony.

Implementing tax reform not only poses a challenge to us at the Internal Revenue Service, but we feel it also provides us with an opportunity to enhance our image as tax administrators and to put into place our new emphasis on improving the quality of our products and services that we are providing to our customers, your constituents, the American taxpayers.

Overall, tax reform provides, we believe, for a fairer tax system, but it is not going to be possible to implement the many changes without some confusion, both at the Internal Revenue Service and for taxpayers. Change causes confusion, and tax reform makes an unprecedented number of changes affecting in some way almost every taxpayer this filing season. I'm now on page 2.

We believe that most taxpayers can handle the changes themselves if they will start early enough to educate themselves about the new law, to understand how it will affect them and what information they will need, and then to begin preparing their returns.

In any event, in order to implement this new law, we at the Internal Revenue Service have attempted to minimize this confusion by doing a number of things. First, we trained our employees on the new law so that they would have the information necessary to successfully administer these new provisions. Cumulatively, we have logged over two and a half million hours of employee training on tax reform, as indicated on page 4.

Releasing draft forms was a second step that we took. We released drafts of the forms earlier this year than we have ever done. We did so in May, June and July of last year, and then we tested those forms on focus groups of taxpayers. The key forms, were the 1040, the 1040A, the 1040EZ, Schedule A involving itemized deductions, form 8606 involving the IRA contributions, and form 8598 relating to the home mortgage interest deduction. All of these were tested by Booz-Allen and Hamilton in 23 cities with 64 focus groups involving over 550 taxpayers across the country.

Another thing that we did to minimize confusion was to keep our forms as similar in appearance as possible and not to deviate from the format that we have used in the past.

And, finally, we have attempted to address the confusion by initiating a significant media effort to convey tax reform information to taxpayers.

For the first time, we did a fall outreach campaign in which we mailed information to over 90 million taxpayers, calling their attention to tax reform and indicating to them how they could order, without cost, a copy of publication 920, spelling out the changes that tax reform makes for individuals. It has been one of our best selling publications ever. We've distributed over 16 million copies to taxpayers already this year.

Another thing we did was to organize national teleconferences so that in the visual medium we were able to carry our messages to our own people within the Internal Revenue Service, to practitioners, to the elderly, and also, more recently, to high school teachers and students with respect to the changes made by this new law and what impact it would have on them this year.

And, finally, we did something unique at the Internal Revenue Service in that we arranged for an advertising campaign through the Ad Council, a nationally known nonprofit organization, which together with McCann-Erickson, an internationally known advertising firm, has come up with a multimedia advertising campaign telling taxpayers how to make their taxes less taxing and urging them to file early this year.

In short, the Internal Revenue Service has worked hard, and we believe we've done a good job in implementing tax reform and preparing for this filing season. But, throughout the year, we wanted to be sure that we were on track and consequently we asked for the following reviews to be conducted to determine how well we're doing. Now I'm on page 7, Mr. Chairman.

In February of 1987, we established our own internal executive steering committee, composed of national office and field officials, to ensure that our planning process was adequate and to elevate issues and concerns about implementation to the appropriate officials.

A second executive team, the Filing Season Readiness Group, was formed to make sure that we were operationally ready for the filing season. This group reviewed service center operations, taxpayer service and forms distribution sites' activities, and found that they were prepared for tax reform. They made a number of recommendations and these recommendations were implemented.

Third, our Internal Audit staff has also been conducting a series of national and local audits to make sure that the Internal Revenue Service is in fact ready for the filing season. Internal audit did not identify any serious problems that would prevent the Service from achieving its implementation goals, but they will continue to monitor our filing season activities throughout this year. I'm on page 9 now.

Finally, we wanted the review of an outside firm because we wanted an independent review of our tax reform implementation process. Therefore we contracted with Booz-Allen & Hamilton last year to conduct a management review of our preparations. Booz-Allen was generally favorably impressed with our analysis and our efforts, and their recommendations have been adopted and implemented as indicated on page 9 of the report.

Turning to page 10, our confidence going into this filing season has to be tempered by a trend over the last several years for taxpayers to file their returns later in the year. For example, in 1983, 14 percent of all individual tax income returns were filed in January, while almost 35 percent were filed in April. Four years later, last year, in 1987, only 4.3 percent of the returns were filed in January, and the number of returns filed in April had climbed to almost 40 percent.

If this trend were to continue and increase this year, many taxpayers might experience difficulty in filing their returns by April 15. Additionally, our processing of returns and issuance of refunds could be slowed. This is a trend that we will be watching closely.

I'd like to now turn to page 13 of the testimony, and go into a status report on the 1988 filing season.

What I'd like to call your attention to now is the first chart, Mr. Chairman, and members of the subcommittee, which shows our re-

ceipts of returns this year. While we started this year with a receipt gap between last year's receipts of return and this year's receipts, and while that gap was 28 percent initially in January, that gap has been diminishing over a period of time. As you can see, it went to 17½ percent, and then 9.7 percent on February 12, and I am pleased to tell you that, as of last week, it was down to 6.7 percent. In short, that gap is closing.

Mr. Chairman, we have a two-part strategy to deal with the unexpected increase in the number of people who may call our toll-free taxpayer assistance telephone lines for information this year. We have been doing projections. We have contingency plans for the unexpected. But we have basically two strategies.

First we are having our field offices extend the hours of operation at all of their toll-free telephone sites, later in the evening, for example, and also many of our regions are actually going into Sundays. All of our regions are open at the taxpayer assistance call sites on Saturdays during the morning.

Our second strategy has been to increase the number of lines and staff at our call sites to handle the increased demand. We have increased the number of our incoming toll-free telephone lines by 30 percent over last year. Similarly, we have increased the number of telephone assistors available to help taxpayers from 3,500 to 4,500 this year.

This year we have initiated a new and statistically reliable method for measuring the accuracy of our toll free telephone assistance inquiries as they relate to technical tax law questions.

Working with our Statistics of Income Division, and also, in cooperation with the General Accounting Office, Taxpayer Service has developed a new integrated test call survey system which became operational in early January of this year. Now I am on page 15.

The new system permits a staff of specially trained personnel, located in our national office in Washington, to place test calls to our answering sites, and thereby assess the courtesy, completeness and accuracy of our telephone assistance.

This system will involve the most extensive testing in this area to date, as approximately 20,000 test calls will be made during the filing season.

Already this year we have completed over 5,000 calls to our taxpayer assistant sites.

A key feature of the new system is its ability to identify error trends quickly, and to send information back to the answering sites so that corrective action can be taken.

Again, already, we have been providing feedback to our call sites on the tax law areas which need improvement, as indicated on page 16.

As of February 13, our new system reports that we are answering 74.8 percent, in other words, 75 percent, of the technical tax law questions correctly. These technical tax law inquiries represent just over half of the total toll free telephone inquiries that we are receiving.

In other areas, such as procedural questions, and questions about taxpayer accounts, our information is that we are answering a much higher rate of questions correctly.

We are obviously not satisfied with answering only three out of four questions correctly. We are not, however, totally surprised by our figures. Our initial results are very similar to GAO's final report for last year, indicating a 79 percent level of accuracy.

Quite frankly the magnitude and velocity of tax changes in recent years has challenged not only the Internal Revenue Service, but practitioners and taxpayers as well. The Tax Reform Act of 1986 was the largest act in our history, and the 1987 revenue provisions were enacted just days before this year's filing season began.

We believe that tax reform will lead to a fairer system. But if the objectives of tax reform are to be met, we urge Congress to pass the Technical Corrections Act as quickly as possible, and hopefully, before April 15.

Beyond technical corrections, however, we urge Congress not to enact any major new tax legislation this year. And we urge Congress to make sure that when legislation places new burdens on the Internal Revenue Service, that appropriate funding is provided in order to permit us to meet these burdens.

This subcommittee has been extremely helpful in assisting us in obtaining the funds necessary to meet tax reform this year. We thank you for it. We look forward to your continued cooperation.

Chairman PICKLE. Commissioner, thank you for that. Let me ask you, what part of the technical correction bill do you have in mind when you're urging its passage?

Mr. GIBBS. Well, I would urge that we do a technical corrections bill that is truly a technical corrections bill, that which simply addresses the omissions, mistakes, problem areas, that were present in the 1986 act.

The bill has been proposed several times, and I would hope that we could act on only those provisions in the near future.

Mr. Chairman, I have just a little bit more, and then I will conclude. But I would like to go to page 19 and to indicate——

Chairman PICKLE. What page?

Mr. GIBBS. Page 19. And indicate that our service centers are in excellent shape for the upcoming filing season. Readiness checks, quality programming and testing efforts, low inventories, and a computer terminal replacement program combine to put us in an even better processing position this year than we have been in the last 2 years.

We expect to have 38,000 employees processing returns during this filing season at the peak, compared to only 35,000 last year. That's on page 20.

As indicated on page 21 our computer hardware and software were tested early this year, and no major problems were identified. Computer operations are in good shape for this filing season.

Installation of our new front end processors is underway in two service centers, and no major problems are being experienced. Additionally, we have replaced the vast majority of our antiquated computer terminals with new terminals as part of the communications replacement system plan, as indicated on page 21.

I'd like now to call your attention to a second chart. This chart shows that we have continued to make excellent progress in reducing our service center inventories. Our service centers are reporting manageable inventories at this time.

For example, this is the adjustments inventory that shows where we were in January of 1986: over 1 million adjustment cases in our service centers. You can see that we more than cut that in half last year. And this year we are down even lower, at 371,000 cases in our adjustments inventory.

Finally, I'd like to turn to the third subject, and that is our plans for the future in redesigning our tax system. Here I would like to take you to page 26 in our testimony. We are continuing to focus on improving our current antiquated tax system, and to coordinate plans for the new tax system redesign efforts. The goal of tax system redesign is to remove the barriers to quality and service in the current system, and to enable us to better serve our customers.

As indicated on page 27, we can give you some examples of what we're talking about. Currently, when many taxpayers call with account questions, we do not have the information to resolve their case available to the IRS personnel who answer the inquiries.

In the redesigned system, we will be able to solve taxpayer problems at the time of the first contact in order to reduce the taxpayer's burden in dealing with the tax system.

A second example: Currently it takes 2 to 6 weeks in order to obtain a copy of the original tax return in order to examine a taxpayer's case. In the redesigned system, electronically stored taxpayer information will be available almost immediately.

We have made significant progress in our systems development this year. We have completed a comprehensive management plan and a process is underway to phase in the newly designed system over a period of years.

In redesigning our system, we are taking a hard look at everything we do and asking ourselves how we can use our technology to provide more timely and better quality service.

At the conclusion of my written testimony, I state that we are renewing our commitment to improve the quality of customer service that we are providing at Internal Revenue Service to our customers, the American taxpayers. Our level of preparation for the current filing season, as well as our tax system redesign plans for the future reflect those twin priorities.

We believe if we improve the quality of products and services that we are providing, and work from a philosophy that the taxpayer is a customer and not just another case, we will earn the taxpayer's respect and confidence, which we need for our voluntary tax compliance system in this country to work properly.

Mr. Chairman, that concludes my oral remarks. We will be happy to try to answer any questions that you or the other subcommittee members have.

[The statement of Mr. Gibbs follows:]

STATEMENT OF

LAWRENCE B. GIBBS

COMMISSIONER OF INTERNAL REVENUE

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss with you what we have done and are doing to meet the challenges of tax reform in the context of the 1988 filing season. I would also like to discuss our plans for the redesign of our tax system that will be necessary to enable us to meet the demands of the future.

With me today are Michael Murphy, Senior Deputy Commissioner, and William Nelson, Chief Counsel. Also joining us are the Taxpayer Ombudsman and the Assistant Commissioners for Taxpayer Service and Returns Processing, Inspection, Computer Services and Information Systems Development.

I. INTRODUCTION

One year ago, when I first testified before this Subcommittee, the Internal Revenue Service was already immersed in planning for the implementation of the Tax Reform Act of 1986. Over the past twelve months, our number one priority has been preparing both ourselves and taxpayers for the sweeping changes of tax reform.

Implementing this historic piece of tax legislation posed an exceptional challenge to the IRS, but it also provided us with a golden opportunity to enhance our image as tax administrators and to put into place our new emphasis on improving the quality of our products and services to our customers - the taxpaying public.

Quality improvement is what IRS is all about these days and it doesn't apply just to tax reform and the 1988 filing season. You will also see our commitment to quality in our plans to redesign our tax system and in many other initiatives underway at the IRS. Our new quality emphasis began with the career employees at IRS before I arrived and will continue long after I'm gone.

My written testimony today describes the actions we have taken to get ready for this filing season and to help taxpayers get ready. It also outlines our vision for the future. I'm proud of the efforts made by our employees at all levels of the organization to get ready not only for the chanllenges and opportunities of this filing season, but also for those that lie ahead.

II. TAX REFORM IMPLEMENTATION

A. PLANNING FOR TAX REFORM

Overall, I believe that tax reform has fashioned a fairer tax system, but it is not without its difficulties, particularly in some areas. Change causes confusion, and tax reform makes an unprecedented number of changes that will affect almost every taxpayer who files a return this year. Therefore, in implementing this historic new law, IRS has attempted to achieve this fairness by dealing with the many changes in a manner which is intended to reduce taxpayer confusion as much as possible.

1. Implementation Plan

Months before President Reagan signed the Tax Reform Act of 1986 into law on October 22, 1986, IRS was already channeling its energies towards deciding how the prospective bill would be administered. Since its enactment, we have hammered out the details of implementation. The end result of this concerted effort was the IRS' Implementation Plan for Tax Reform, which is our agency's basic planning document for administering the new law. For each tax reform provision, our Implementation Plan identifies each action we will take and when we will complete it.

While the Tax Reform Implementation Plan provided a road map of what needed to be done, the sweeping changes resulting from tax reform required us to expand substantially our traditional approaches to implementing new tax law. The Tax Reform Act made such fundamental changes in so many areas that we knew that we needed to be innovative and to start early to educate ourselves and taxpayers about the changes.

2. IRS Goals and Training

Early in the implementation process we identified four major goals and developed an overall communications strategy to emphasize the dual themes of readiness and customer service. Internally, we worked to instill confidence in our employees across the country and to develop our emphasis on quality. Externally, we explored new ways to both focus taxpayers' attention on the challenges of this filing season and to communicate to taxpayers the information they needed to know.

To accomplish our goals we began by training our employees on the new tax so they would have the information necessary to successfully administer these new provisions. Last summer, we conducted tax reform implementation seminars across the country for all our executives to explain the new law and what we as an organization were going to do to carry out the new law. Training on tax reform has also been a top priority for all our employees. Cumulatively we have logged over 2.5 million hours of employee training on tax reform. To be ready for the anticipated increase in taxpayer questions this year, we have been working particularly with our Taxpayer Service front line employees and managers in an attempt to increase our taxpayer education and assistance capabilities.

3. Early Guidance

Throughout the summer, we released draft forms in order to obtain public comment and to permit taxpayers and practitioners to receive basic information on the new provisions. We also tested the new forms using focus groups of taxpayers or practitioners. To do this, IRS contracted with Booz-Allen Hamilton Inc. In 23 cities across the country, Booz-Allen conducted 64 focus groups with over 550 taxpayers to test forms 1040, 1040A, 1040EZ, Schedule A (itemized deductions) form 8606 (IRA contributions), and Form 8598 (home mortgage interest). These tests alerted us to areas of potential confusion on the forms and instructions that we could correct before printing the final version of the forms.

Knowing that the substantial number of tax law changes would challenge taxpayers, we made every effort to keep this year's forms similar in appearance and format to those used in prior years. Many taxpayers will find that their returns are much like last year's and no new forms or schedules will be needed. Other taxpayers, particularly those with more complex returns, may have one or more new schedules or computations to complete.

Taxpayers and practitioners also depend on the timely issuance of legal guidance in order to file returns. Through February 17, 1988, the IRS has issued 268 separate items of guidance under the Tax Reform Act. Specifically, we have published 42 regulations, 82 Notices, 74 Announcements, 32 Revenue Rulings, 20 Revenue Procedures, and various treaties, delegation orders and other items.

4. Taxpayer Outreach

To effectively convey the tax reform message to the American public we initiated a unique Fall Outreach Campaign. This campaign was kicked off last October when we sent a pamphlet to over 90 million taxpayers, alerting them to the new law and urging them to begin thinking early about taxes rather than putting it off until they would normally prepare their returns. The pamphlet included an order blank for the new Publication 920 which is an excellent plain-language explanation of the Tax Reform Act changes for individuals. So far, we have filled over 16 million orders for this publication, making it the most popular IRS publication that we have ever had.

As another part of the Outreach campaign, we mobilized IRS employees, practitioners, and volunteers across the country through a series of activities including media events, seminars and institutes, speeches and special assistance days.

For the first time in our agency's history, we have conducted national teleconferences to communicate important tax information to our own employees, practitioners, volunteers, and other groups including retired persons and high school teachers and students. For the past sixteen months, we worked closely with the media nationwide to publicize the changes under tax reform. We also have begun a series of briefings with members of the media to provide them with up to date information on the status of the 1988 filing season.

This January, the IRS joined forces with the Advertising Council to launch an innovative nationwide campaign to inform over 100 million taxpaying Americans about how the recent changes would affect them. Working with the New York ad agency, McCann-Erickson, the IRS is conducting a major multi-media campaign to "Make Your Taxes Less Taxing" by filing early and accurately. The advertising campaign budget this year is just over $1 million and is expected to generate more than $25 million in donated advertising time and space in the nation's media.

B. REVIEWING OUR PROGRESS

The IRS has worked hard on implementing the Tax Reform Act of 1986 and preparing for the 1988 filing season. We believe that we've done a good job in taking some innovative actions to implement this new law. But throughout the year we wanted to be sure that we were on track and consequently asked for the following reviews to be conducted to determine how well we were doing.

1. Executive Reviews

Shortly after tax reform was enacted, we established an executive team of selected National Office officials. Their role was to advise us on our progress in planning for implementation and to bring to our attention those issues requiring policy decisions. In February 1987, we expanded our internal oversight activities by establishing an Executive Steering Committee for Tax Reform, composed of both National Office and field officials. It was the committee's job to ensure that our overall planning process was adequate and to elevate issues and concerns about implementation to the appropriate officials.

A second executive team, functioning as a subgroup under the Executive Steering Committee, was charged with the responsibility of ensuring that the IRS was operationally ready for the 1988 filing season. Conducting their reviews during the summer and fall of 1987, the Readiness Group found all three functional areas - - service centers, taxpayer service, forms and

distribution sites - - intensely involved in planning for the implementation of the Tax Reform Act and preparing for the 1988 filing season. Overall, they concluded that the planning effort was thorough and of high caliber. Where the Readiness Group had recommendations, these recommendations have been carried out.

2. Internal Audit

Our Internal Audit staff also conducted a series of national and local audits to ensure that the IRS was ready for the 1988 filing season and they will continue monitoring our activities throughout the filing season. Specifically, Internal Audit is reviewing our taxpayer service activities, our software development process, our individual and business income tax processing activities (including electronic filing capabilities), our tax material distribution program and our taxpayer compliance programs.

Internal Audit did not identify any problems that would prevent the Service from achieving its goals for implementing tax reform. They did, however, identify several areas that needed further attention, including form instructions, taxpayer service staffing and service center processing procedures. Our functional executives and managers have reacted quickly to Internal Audit's recommendations and corrective actions have been taken or are underway.

3. Booz-Allen Report

We specifically asked for a review by an outside firm because we wanted an independent review of our tax reform implementation process to validate our own internal controls. We contracted with Booz-Allen & Hamilton Inc. to conduct a management review last summer in order to examine our initial plans and development actions for implementing tax reform. Their task was to identify any significant planning deficiencies that could jeopardize our ability to implement the new law or administer the tax system.

Overall, they were favorably impressed with the implementation planning effort, the execution of our plans to date, and the dedication and commitment of IRS managers and executives in providing quality customer service to the taxpaying public. In their words, "Clearly, the IRS is committed to a comprehensive translation of the law into its operations." Their recommendations also have been adopted and implemented.

C. PREDICTING TAXPAYER BEHAVIOR

Having said all this, our confidence level has to be tempered by the fact that there is one important factor that is ultimately outside our control--the filing patterns of taxpayers themselves. The one major concern that emerges out of our data is that taxpayers may file later than ever.

1. Return Projections

We know from our research that over 2 million low income filers will no longer be required to file returns this year because of Tax Reform changes such as the increase in the personal exemption and the standard deduction. However, some will file in order to obtain the Earned Income Credit or a refund of tax withheld. We also project that over 3 million new taxpayers will file returns because of the repeal of the personal exemption for dependents who can be claimed on their parents' return.

Tax Reform will, however, allow taxpayers to shift to simpler returns. The increase in the standard deduction and the elimination or reduction of other items (such as income averaging, the deduction for working married couples, and certain itemized deductions) will result in over 3 million filers becoming nonitemizers who can file the simpler Forms 1040A and 1040EZ.

2. Late-Filing Trend

The most troubling data we have concerns the trend towards filing later in the filing season. In 1983, 14% of all individual income tax returns were filed in January and 34% were filed in April. Four years later, in 1987, only 4% of the returns were filed in January and the number of returns filed in April had climbed to over 39%. If this trend were to increase significantly, many taxpayers might experience difficulties in completing their tax returns before the April 15 deadline because of the demands placed on IRS and tax return preparers. Additionally, it could significantly slow down the processing of returns and delay the issuance of refunds. If we don't process returns within a 45 day period after the return due date, the government must pay interest on refunds.

Surveys conducted on the reasons for this trend have identified procrastination and the lateness in receiving all information necessary to file a return as the principal causes. To combat this growing trend, our Ad Council campaign encourages taxpayers not to put off working on their returns. Although many taxpayers will find their returns are simpler, some will be faced with more complex returns. Our approach, therefore, has been to urge taxpayers to begin early to: (1) determine how the changes will affect them personally, (2) obtain the information and records they will need to complete their returns, and (3) accurately prepare and file their returns with us.

3. Underwithholding

Another concern was whether many taxpayers would be seriously underwithheld if they did not adjust their withholding by submitting a revised Form W-4. This would result in a tax return with a balance due instead of a refund.

Surveys conducted for IRS show that W-4 compliance in 1987 was relatively good. Additionally, the total dollar amounts of both individual withholding and estimated tax payments are up over last year. Overall, the statistics indicate that most taxpayers were not underwithheld or underpaid in 1987. But pockets of underwithholding could exist among certain groups of taxpayers such as high income taxpayers, working couples and young wage earners. Research activities are underway to determine the existence and extent of these problems.

III. 1988 FILING SEASON

Mr. Chairman, it was just three years ago that the IRS and American taxpayers underwent what we all can agree was the worst filing season ever. Millions of refunds were held up for weeks and months. The problems with processing returns resulted in tremendous backlogs of other service center work. Our Taxpayer Service personnel, already under strain due to reductions in staffing and funding, were overwhelmed.

We have come a long way since then. Both the 1986 and 1987 filing seasons have been unqualified successes. Going into this year with so many tax changes, we take a certain amount of comfort from the successful back-to-back filing seasons during the last two years.

Nevertheless, to meet the challenge of tax reform this filing season, we have increased our staffing over prior year levels. Our people have received additional training. Our equipment is better. We have more checks in place to monitor problem areas. We are ready earlier than we have ever been. And I have observed first hand the dedication of our employees to making this filing season successful.

A. PROVIDING TAXPAYER ASSISTANCE

A great deal of planning has gone into our Taxpayer Service operations. Without question, the vast number of tax law changes has required creativity and flexibility in the way Taxpayer Service does things this year. This, along with an increase in resources, has made Taxpayer Service one of the most exciting and challenging areas to work in at the IRS.

1. Taxpayer Service Readiness

We have increased the number of our incoming toll free telephone lines for taxpayers to contact us on by almost 30% over last year to 4,359 lines. We have increased the number of telephone assistors available to help taxpayers from 3,500 in 1987 to 4,500 in 1988. Total staffing has been increased by approximately 1,300 staff-years to a total of 7,245 staff-years. (See Appendix A)

This increase in staffing reflects two strategies for our toll-free service this filing season. We expect the number of people requiring assistance to increase because of the additional questions relating to tax reform. This filing period we estimate that 22 million people will be assisted on our toll free lines compared to 17 million callers in 1987.

Therefore, our first strategy to handle the anticipated increased demand is to maximize the opportunities for everyone needing tax assistance to get it by having our field offices extend the hours of operation at their toll-free telephone sites. All regions will provide toll-free taxpayer service on Saturdays and some will also be open on Sundays. This helps us spread out the incoming telephone traffic and we have found that many people use weekends to work on their tax returns.

Our second strategy to handle the anticipated increase in calls is to increase our telephone circuitry. We, therefore, have increased the circuitry at all of our call sites to handle peak demand. Should it be necessary, each of the seven regions will be able to handle an increase of approximately 20 percent above expected telephone demand by increasing circuitry above current levels and/or by implementing one or more of several options to increase staff-hour availability on the telephone. Altogether these actions ensure that our offices are equipped to handle a larger volume of calls this filing season.

2. Taxpayer Service Accuracy

Following the 1987 filing season, questions arose regarding the validity of our methods of measuring the accuracy of our technical responses on the toll-free telephones. Telephone surveys conducted by the General Accounting Office (GAO) and national, regional and district offices identified a far lower accuracy level on technical questions than was reflected by our own system. For instance, last year GAO reported that the Service was answering 79% of the tax law inquiries correctly.

In response, we have initiated a new, sophisticated and statistically reliable method of measuring our accuracy for the purposes of improving our technical performance. Taxpayer Service and the Statistics of Income Division (SOI) have worked in close cooperation with GAO to develop the new Integrated Test Call Survey System which became operational in early January of this year.

The new system permits a staff of specially trained personnel located in our National Office here in Washington to place test calls to our answering sites and thereby assess the courtesy, completeness and accuracy of our telephone assistors. By using a sophisticated, computerized system to record response results and to gather information from our field staff on actual calls from taxpayers, we are able to ensure that our statistics accurately reflect the quality of our responses with respect to the types of questions which we are actually receiving from the public.

Approximately 20,000 test calls will be placed to 29 of our toll-free sites during the filing period. This represents the largest sample of test calls ever used to evaluate taxpayer service accuracy and already we have made over 5,000 calls. The questions asked are a combination of GAO's previous test questions as well as newly developed ones that were designed to be representative of the types of questions which we receive. Test callers have been selected based on their technical expertise, telephone systems experience and suitability to the task.

A key feature of the new system is its ability to identify error trends quickly and to send information back to the answering sites so that corrective action can be taken. While it is still very early in the filing season, we have already been providing feedback to our call sites on tax law areas which need improvement based upon the data we have.

Our toll-free telephone sites are prepared to provide assistors with supplemental training if necessary. In addition, many district offices will devote time each week to a discussion of technical tax topics which are identified as "improvement areas" in that office. We believe that this new approach represents a significant step in enabling us to measure our level of technical performance and improve the quality of our telephone assistance to taxpayers.

As of February 13, our new system reports that we are correctly answering 74.8% of the technical tax law questions which our toll free telephone system receives. Our system has also identified that in 14.3% of our correct responses each of the following would be appropriate: (1) additional probing for taxpayer information related to the question asked, (2) additional information regarding forms and publications related to the question asked, or (3) additional courtesy.

We are obviously not satisfied with answering only 3 out of 4 questions correctly at this time. We are not, however, totally surprised by our figures. Our initial results for this filing season are very similar to those in GAO's final report for last year's filing season. (See Appendix B) The large number of tax law changes this year was bound to challenge our assistors despite our training and planning efforts.

Moreover, the challenges of this filing season seem to be affecting practitioners as well. For instance, last week USA Today reported that a sample tax question given to 50 practitioners resulted in 50 different answers. Similarly, in providing several sample test questions to the Wall Street Journal recently, a Big Eight accounting firm initially provided the wrong answer to its own question.

Very simply, taxpayers, practitioners, and the IRS are having trouble coping with the magnitude and the velocity of tax law changes. Since 1976, Congress has enacted major tax legislation in almost every year. The Tax Reform Act of 1986 was the largest tax bill in our history and the 1987 revenue provisions were enacted just days before this filing season.

Tax reform was necessary to provide a fairer tax code and thereby maintain the integrity of our voluntary tax system. If the promise of tax reform is to be achieved, however, the recipe for success includes three key ingredients:

- Technical corrections should be enacted as soon as possible to eliminate the confusion and uncertainty which exists in the areas addressed in that legislation,

- There should be no other major tax legislation enacted this year in order that taxpayers, practitioners, and the IRS can adjust to the recent tax code changes, and

- Should Congress enact legislation placing additional administrative burdens on the IRS, that legislation should be accompanied by the necessary funding to actually implement the legislation.

3. Contingency Plans

Our Taxpayer Service contingency plans ensure that we will have trained IRS employees available to answer taxpayer inquiries and backup systems and sites ready to meet any operational problems that may arise. We have emphasized early hiring and retention of our seasonal front-line assistors, and we have experienced technical personnel available to provide backup support.

Additional telephone lines have been added at most toll-free telephone sites to handle the anticipated high volume of taxpayer inquiries and backup systems are being installed at several sites to relieve potential stress situations. In addition, if operational problems arise at any of our answering sites, the incoming calls can be rerouted to any one of our three emergency sites located at Indianapolis, Jacksonville and Houston. If for any reason the emergency sites are not able to handle the transferred call volumes, a number of other call sites could assume additional telephone workload as necessary.

B. DISTRIBUTING FORMS AND PUBLICATIONS

Filling orders for forms and publications is a critical element of any filing season and this is especially true this year. Taxpayer and practitioner demand for the new tax reform material is already very high. We have worked hard to make sure that the public receives the information they need on a timely basis.

1. Forms Distribution Readiness

Two years ago we began installing a toll-free telephone system to make it easier to order our tax forms and publications. That system is now fully operational with hours of operation from 8:00 a.m. to 8:00 p.m. Monday through Friday and 9:00 a.m. to 3:00 p.m. on Saturdays. This year we have increased the number of toll-free lines for ordering materials to 539 lines compared to 370 lines last year.

Most orders are being processed and mailed within 48 hours after they are received at a center. This is much faster than last year when the turn-around-time was approximately four days. In addition, as a result of our increased marketing efforts last year, 32,000 banks, 23,000 post offices and 20,000 libraries will stock IRS forms and publications this year.

2. Contingency Plans

Our facility at Florence, Kentucky, has been designated as the backup distribution site. We will also have the ability to transfer incoming taxpayer calls between sites. These and other available options will enable us to handle almost any emergency situation that could arise this filing season.

C. PROCESSING TAX RETURNS

IRS service centers are in excellent shape for the upcoming filing season. Readiness checks, quality programming and testing efforts, low inventories, and a computer terminal replacement program combine to put us in an even better processing position than last year -- which was an excellent year.

1. Service Center Readiness

This year, we expect that our 10 centers will receive over 107 million individual income tax returns, more than ever before. (See Appendix C) To be ready for this filing season, we expect to have 38,000 employees processing returns during the filing season peak compared to 35,000 employees last year. So far we have not experienced any serious recruitment problems at the service centers. The only service center where there was any concern was the Andover center in early January. However, as the result of an innovative job fair conducted over one recent weekend, we received over 1,000 applications for various returns processing jobs, far above what we expected.

Before the filing season each service center was visited and extensively briefed by teams of management officials and analysts. Tax reform issues and techniques and resource needs for the processing of returns were addressed during these visits. Service center instruction manuals were revised and made available well in advance of the filing season. Special emphasis was placed on testing and perfecting these procedures as employees were trained to use them. This review of and attention to processing procedures is vital to the accurate processing of tax returns.

2. Computer Operations

We likewise are satisfied with our computer software and hardware. Our tax processing computer programs have been revised, reviewed and tested for this filing season. This year's programming and systems acceptability testing efforts have been very successful and we are already beginning to see the rewards of the aggressive testing effort we undertook this year. We have had fewer start-up problems than ever before and the number of problems reported to our National Office Command Center is down significantly.

This fall, hardware readiness reviews were conducted at each service center, the National Computer Center and the Detroit Data Center. The reviews focused on our mainframe 1100 systems, front-end processors, laser and non-impact printer systems, Remittance Processing System and the Distributed Input System. No major problems were identified and the computer room operations are in good shape for the filing season.

We are also proceeding with our Communication Replacement System Plans. Installation of the new front-end communication processors is underway at two service centers and will be completed nationwide prior to the 1989 filing season. Those service centers which are installing the new front-end processors this filing season have retained their existing systems to provide tandem processing capability.

Before the filing season, we replaced the vast majority of antiquated computer terminals which are used by IRS employees at our service centers and district offices to update and retrieve information on taxpayer accounts. All 1,700 district office terminals have been replaced and 450 additional terminals have been installed at district office Taxpayer Service sites. In addition, 1,500 service center terminals have been replaced and 410 additional terminals have also been installed. By November 1988, all of the remaining old terminals will be replaced, and 365 more Taxpayer Service and 800 more service center terminals will be installed.

With respect to our computer utilization and capacity, various studies show that IRS has the computer resources to meet the needs of this and future filing seasons into the 1990's. In addition, a series of IRS management initiatives, including software optimization and workload redistribution, are underway to ensure adequate capacity through 1994, by which time tax system redesign should allow the transfer of work from the existing Service Center Replacement System.

3. Service Center Inventories

Our inventories of potential problem areas within our service centers (unpostables, adjustments and correspondence from taxpayers) are at manageable levels. After the 1985 filing season, these inventories mushroomed and became a serious problem that undercut taxpayer and practitioner confidence in our ability to resolve problems that arose during the processing of tax returns.

We are pleased to report that the excellent progress we made in reducing these workload inventories in 1986 continued throughout 1987. In fact, going into the 1988 filing season, all service centers reported that their inventories were manageable. Our adjustments inventory declined from 1.1 million cases in January 1986 to 359,000 cases in January 1988. Our unpostable inventory also has dropped from 1.6 million cases in January 1986 to 432,000 cases in January 1988. (See Appendix D.)

4. Electronic Filing

This year, the IRS has significantly expanded electronic filing. We expect the number of electronically filed tax returns to reach between 500,000 and 1 million returns this filing season compared to 80,000 last year. (See Appendix C.)

Overall, sixteen IRS districts are now covered under this program and our service center in Ogden, Utah has joined our Cincinnati Service Center in processing returns electronically. Because of the success of electronic filing, we have also expanded the program to cover the more complex refund Forms 1040, including all major forms and most schedules.

One of the major advantages of electronic filing - electronic funds transfer - is now available to taxpayers in all of the 16 participating districts. Taxpayers can request that their refund be deposited directly into their personal savings or checking account. This method minimizes loss or theft and also provides for a speedier refund.

Electronic filing substantially accelerates the issuance of refunds. In the past, refunds for electronically filed returns have been issued up to three to four weeks earlier than normal paper processing. Also, our experience shows that returns filed electronically contain fewer errors. Previously, error rates in preparing and processing paper returns have remained around twenty percent; error rates in electronically prepared and processed returns have been about two percent.

5. Contingency Plans

Our service center contingency plans emphasize the early monitoring of tax return receipt patterns to identify any unexpected trends and the ability to transfer workload between centers. In addition, the National Computer Center can provide computer support if a service center's Sperry 1100 system workload exceeds available resources.

D. MONITORING THE FILING SEASON

We believe we have done a good job in getting ready for the 1988 filing season. But we intend to closely monitor our actual performance during the course of the next several months. We have set up communication networks that will allow us to quickly identify and take action on any problems that may arise.

1. Conference Calls

Like last year, the National Office is very involved in close and regular communication with the field offices. Each week during the filing season National Office taxpayer service and public affairs offices conduct a conference call with regional tax reform coordinators and public affairs officers. The calls serve as two-way communication: Regions provide the National Office with information regarding the progress of the filing season as well as receive information from the National Office regarding expectations, trends, and problems reported over the last week.

A second executive-level call is also conducted weekly. This call deals primarily with issues such as staffing, the status of operations, comparisons between scheduled and actual volumes of work. It allows National Office executives with overall responsibility to discuss those issues with field executives who have local responsibility for the same functions.

2. Management Information Systems

We also have several statistical reporting systems in place to monitor filing season activities in both service centers and district offices. Quality monitoring systems are in place and can provide daily feedback within a local office. This information is passed on to the National Office on a weekly basis for analysis. Inventory levels of service center workload, volumes of returns received and processed and refunds issued, all with comparisons to last year, are accumulated on a weekly basis by the National Office for analysis.

3. General Oversight

Finally, we have several offices that are committed to monitoring the filing season. Our National Office Command Center, a 24 hour a day office that monitors the status of our computer processing, reports that in January, even with the large number of tax reform changes, we had a significant reduction in the number of problems over the same period last year. In addition, no taxpayers have been affected by any of these problems.

Our Problem Resolution staff has also been instructed to report any problems that they might become aware of during the filing season. Thus far, they have not reported any serious problems.

IV. TAX SYSTEM REDESIGN

At this point, I would like to switch from talking about the present to address the future. Specifically, I'd like to discuss with you our plans for redesigning our tax system for the 1990's.

A. The Tax System of the Future

The goal of our tax system redesign efforts is to remove the barriers to quality and service in the current system and to enable IRS to better meet its obligations to the public. Right now, we can't provide the level or quality of service that we feel we ought to be providing. We can't get information we already have out of our antiquated tax processing system in order to do the job like it should be done. Taxpayers are not satisfied with the level and quality of our service and, frankly, neither are we.

Our new systems will change how we do business for the better in the following ways:

- With current systems, many taxpayers call with an account problem, only to be told that the information necessary to resolve their case is not available. In redesigned systems, IRS will be able to help taxpayers at the first point of contact, significantly reducing the taxpayer burden imposed by the current system.

- In our present paper intensive systems, it normally takes a minimum of two, and often up to six weeks for an employee to obtain a copy of an original tax return. To speed resolution, taxpayers now are sometimes asked to provide another copy of the tax return that we already have. In redesigned systems, electronically stored tax return information will be available immediately.

- The processing of tax returns under current systems is manually intensive and error prone. In redesigned systems, on-line validation and the automation of many manual processes in handling these returns will result in a system less susceptible to error, providing a better quality and more timely product to the taxpayer.

As you can see, our focus is on solving the problems of the current system, so that we can keep erroneous information out of the system and be more responsive to both our own employees and taxpayers. We believe we will be able to do this by taking advantage of the technology that is available today.

B. Current Status

I am pleased with the progress we have made in our systems development effort since last year. We have completed a comprehensive management plan that describes a vision of what we would like our system to look like in the early 1990's and into the late 1990's. The plan also describes the process that will allow us to achieve our vision. The process is well underway. We have completed a design concept which allows us to phase in the redesigned system in a way that minimizes disruption and risk.

I have gone into some detail because I believe that it is important to understand that our redesign effort is about more than simply replacing an antiquated tax administration system that is beginning to groan under the weight of demands it was not designed to meet. In redesigning systems, we are taking a hard look at everything we do and are asking ourselves how to use technology to provide more timely and better quality service. The Internal Revenue Service is committed to providing an improved level of service through a coordinated systems planning and development process that embraces information technology.

V. CONCLUSION

We are renewing our commitment to quality and customer service. The level of preparation for the filing season as well as our tax system redesign plans reflect those twin priorities. We believe if we improve the quality of the products and services that we are providing, and work from a philosophy that the taxpayer is a customer and not just another case, then we will earn the taxpayer's respect and confidence which we need for our voluntary compliance tax system to continue to work properly.

APPENDIX: A

TAXPAYER SERVICE

Item	1987	1988
Telephone lines	3,469	4,359
Toll-free assistors	3,500	4,500
Total field staffing	5,989	7,245
Phone calls to date	6.5 million	7.2 million
Total filing season calls (1988 is projected)	22.5 million	26.0 million
Total filing season calls IRS will answer (1988 is projected)	17.5 million	22.2 million
Current level of service	75%	84%

APPENDIX: B

ACCURACY RATES

INDIVIDUAL TAX LAW INQUIRIES
PERCENT CORRECT

National Average	1987*	1988**
Correct Responses	79%	74.8%

* Source: GAO Report 12/3/87
**Source: IRS' new Integrated Test Call Survey reflecting approximately 5,000 test calls during the four week period ending February 13, 1988.

Regional Averages	1988***
Southeast	78.9%
Central	77.9%
Midwest	76.7%
Southwest	73.7%
Mid-Atlantic	73.6%
Western	72.8%
North Atlantic	69.3%

***Source: IRS' new Integrated Test Call Survey reflecting approximately 5,000 test calls during the four week period ending February 13, 1988. Information is not available for 1987 because the Integrated Test Call Survey was initiated by the IRS in January 1988.

APPENDIX: C

RETURNS AND REFUNDS

INDIVIDUAL INCOME TAX RETURNS
RECEIVED AND PROCESSED

Returns Received and Processed in Service Centers Through February 13, 1987, and February 12, 1988. (In Thousands)

Weekly		1987	1988	Percent Change
Receipts:	1040	3,467	3,376	-2.6%
	1040A	2,160	2,172	0.6%
	1040EZ	2,022	2,162	6.9%
	Total	7,649	7,710	0.8%
Processed:	1040	1,249	1,007	-19.4%
	1040A	959	976	1.8%
	1040EZ	1,008	972	-3.6%
	Total	3,216	2,955	-8.1%*
Cumulative from January				
Receipts:	1040	7,172	6,235	-12.9%
	1040A	5,893	5,109	-13.1%
	1040EZ	5,729	5,611	-2.1%
	Total	18,784	16,955	-9.7%
Processed:	1040	2,136	1,804	-15.5%
	1040A	1,888	1,683	-10.9%
	1040EZ	1,913	1,889	-1.3%
	Total	5,937	5,376	-9.4%*

*Reductions in income tax returns processed compared to last year are a function of the reduction in receipts. Service center staffing is maintained at a level which can most effectively and efficiently process returns given the amount of current receipts. The service centers are not experiencing any major problems in the processing of returns.

ELECTRONIC FILING

Returns Accepted (Through 2/12/88)

Cincinnati Service Center	75,115
Ogden Service Center	21,263
Total	96,378

Note: Total returns accepted during the entire 1987 filing season totalled 77,612.

REFUND COMPARISON REPORT

Refunds certified by the National Computer Center through February 12, 1987, and February 13, 1988

	1987	1988	Change
Weekly			
Number (thousands)	1,428	1,188	-16.8%*
Average Refund	$698	$783	12.1%
Cumulative			
Number (thousands)	1,941	1,716	-11.6%*
Average Refund	$658	$743	12.9%

*Again, the reduction in the number of refunds compared to last year is a function of fewer returns being received by the service centers and consequently fewer returns having been processed at this point in time. The processing time for refund returns is similar to last year at this time.

APPENDIX: D

SERVICE CENTER INVENTORIES

ADJUSTMENTS INVENTORY AT THE BEGINNING OF THE YEAR

Service Center	Jan 1986	Jan 1987	Jan 1988
Andover	68,511	53,777	40,046
Atlanta	147,874	70,391	45,803
Austin	176,718	61,461	39,493
Brookhaven	110,734	73,536	38,464
Cincinnati	26,656	36,228	26,424
Fresno	183,788	55,011	52,028
Kansas City	47,540	32,980	25,341
Memphis	69,344	55,073	28,501
Ogden	77,046	39,587	38,155
Philadelphia	221,845	64,832	36,964
NATIONAL TOTAL	1,130,056	542,876	371,219

All service centers entered into the 1988 filing season with inventories within our prescribed manageable levels.

CURRENT ADJUSTMENTS INVENTORY

Service Center	Feb 14 1986	Feb 13 1987	Feb 12 1988
Andover	73,222	52,129	38,957
Atlanta	107,512	71,770	31,284
Austin	158,536	43,456	39,733
Brookhaven	121,797	63,417	34,112
Cincinnati	27,952	27,630	20,978
Fresno	161,598	48,093	46,154
Kansas City	46,521	24,370	36,222
Memphis	65,005	34,040	22,200
Ogden	75,157	41,005	30,314
Philadelphia	208,163	58,746	33,863
NATIONAL TOTAL	1,045,463	467,656	333,817

UNPOSTABLES INVENTORY AT THE BEGINNING OF THE YEAR

Service Center	Jan 1986	Jan 1987	Jan 1988
Andover	100,321	53,678	40,522
Atlanta	215,480	121,241	41,721
Austin	253,160	70,042	60,116
Brookhaven	236,565	90,580	46,527
Cincinnati	84,084	45,962	26,178
Fresno	274,715	76,713	57,426
Kansas City	73,367	64,893	49,780
Memphis	126,629	46,706	32,339
Ogden	76,609	34,464	33,884
Philadelphia	180,532	114,185	43,656
NATIONAL TOTAL	1,622,452	718,464	432,149

All service centers entered the 1988 filing season with inventories within our prescribed manageable levels.

CURRENT UNPOSTABLES INVENTORY

Service Center	Feb 14 1986	Feb 13 1987	Feb 12 1988
Andover	87,440	48,559	42,574
Atlanta	231,009	107,265	39,231
Austin	240,293	62,951	40,472
Brookhaven	239,585	79,446	41,327
Cincinnati	85,028	40,578	18,498
Fresno	239,922	72,873	57,929
Kansas City	79,290	48,278	34,628
Memphis	119,078	42,852	34,955
Ogden	76,567	28,273	18,892
Philadelphia	187,454	68,332	59,260
NATIONAL TOTAL	1,585,666	599,407	388,036

Chairman PICKLE. Well, we thank you, Commissioner. And first and foremost, I want to thank you for informing the committee of the extensive planning efforts the IRS has put into effect to try to cope with the big change in the tax laws, as well as putting emphasis on the taxpayer services. I think your administration will be remembered as being the first to put great emphasis on taxpayer services.

Now, the question is, how are you handling it? When I listened to your testimony, I had the feeling that I should be relaxed, that there is no problem in the world out there, and that everybody is happy, people are paying their taxes, and they're on schedule.

I don't think the facts show that. A national publication just put out a headline, a news magazine this week, says, "Tax Terror," and cites all the emergencies and great crises that are out there.

I want to try to nail down some of the facts on it and see how we're doing.

First, let's get into the question of the telephone assistance and people calling in. I'm glad you've got a quality assurance program. I'm surprised it's the first time you've ever put one into effect down there, but I'm glad you have it.

Now, the question is, how many times are people getting the correct answer when they call one of your toll-free services? You've just conducted a survey. How many times does it show that your agency was giving the correct answer?

Mr. GIBBS. Our survey shows, and I am comfortable, that we are answering three out of four questions correctly.

Chairman PICKLE. That would mean 74 percent.

Mr. GIBBS. 75 percent, yes, sir.

Chairman PICKLE. Or nearly 75 percent. Now, are you improving from January to February, that percentage?

Mr. GIBBS. The first thing we wanted to do, Mr. Chairman, is to be sure that we had a statistically valid sample before we put out the number.

We have sampled over 5,000 calls, and we have taken a hard look at how we are measuring our accuracy. We have been working with the Government Accounting Office. We are using their software from the standpoint of computing our accuracy.

We are weighting the answers we get in the way that we are measuring our accuracy so that we are comfortable that when we tell you it's 75 percent, it's 75 percent in terms of the total number of calls.

Chairman PICKLE. Well, let's put it another way. While you're satisfied that three out of four answers are correct, when you're getting, according to your figures, only 74 percent of them correct, that means that one-fourth of the people who make calls to the IRS toll-free services are being given the wrong information.

Now, I don't know that that's a complimentary figure to say that we're only wrong 24 percent or 25 percent of the time. GAO gives you a much lower rating, and we'll be hearing from them later this morning. They said the correct answer is given only about 57 percent of the time.

And I'm advised that Money Market magazine says your accuracy rate is only 55 percent. This is on technical questions that they're asking.

Now, I ask you this question: Do you have in place now a computerized information service on all these questions?

Mr. GIBBS. Yes, we do, Mr. Chairman. Could I go back because you have covered about three or four things. And I think it is important in this area that we really try to respond to you on the various things.

First, we do have a computerized system. However, let's distinguish between some things. Let's distinguish between the accuracy of the answer, whether the answer is correct or not; whether, if the taxpayer follows the advice and puts it down, whether they're going to accurately prepare the return. That's what the 75 percent number is.

Now, in addition to that, Mr. Chairman, we are also, as a management technique, encouraging our people to be courteous; to also try to provide taxpayers with additional information like forms and publications.

And we're encouraging them in appropriate circumstances to actually ask some questions before they give the answers. We are not doing as well in that area, those three areas; and that is a lower number than the 75 percent number.

But the 75 percent number does reflect accuracy. And I would like to make the point that that is 5,000 telephone calls. It's not a couple of hundred. It's not a handful from some of the newspapers. It's 5,000 calls. And those answers are weighted by the type of calls that we get.

So I think it is a much fairer indication of the accuracy of our telephone assistance.

Chairman PICKLE. I did not think that you had put into effect a computerized information system. One of the former Commissioners has testified to us that they were concerned about the delay that you've had in implementing the computerized service.

And I don't think you're ever going to be able to handle big volumes unless you have a computerized system. How long has it been in place?

Mr. GIBBS. I think I understand. I thought you meant, have we computerized this technique to analyze our quality.

Chairman PICKLE. No, no.

Mr. GIBBS. You're asking, have we provided our taxpayer assisters with computers.

Chairman PICKLE. That's right.

Mr. GIBBS. We hope later this year to begin to test a pilot version of a computerized taxpayer assistance site, Mr. Chairman. That is something that we are working on. We do not have it in place yet, but it is coming.

Chairman PICKLE. All right, let me go to one or two other questions, because I want each member to be able to ask questions as we go along here.

Now, the GAO reports to us that they found in some of these offices—they listed four or five of them—that these offices didn't have 41 of the 223 forms. This was last month.

Has that been corrected?

Mr. GIBBS. Mr. Chairman, it has been corrected at the particular office. We also are taking a hard look at this in our other offices. But I would like to clarify something.

You have to be very careful when you're looking at the particular forms and publications. We have some forms that are not widely used, and for that reason, we ask taxpayers to simply call a toll-free number.

Our turn-around time now to get back to them is about 24 hours, if they'll call in and ask for a specific form, in terms of filling that order and having it back to them in a matter of days.

So with respect to certain types of forms that are not widely used, we do encourage taxpayers to order them by telephone, rather than try to stock them in every one of the sites across the country.

Chairman PICKLE. In some of the offices our people have visited, they have run out of forms, and they said, well, when we run out of forms, we order some new ones.

Surely you don't wait until your supply is gone and then place an order. Do you have any kind of a computerized system in advance that enables you to order these forms? Why should you ever be short of forms?

Mr. GIBBS. Well, let's go back for a second. I think that it is certainly a valid criticism to say that we should not wait until we are out of forms to order forms.

What we have done as a result of this and also some other information that has come to us is to go back to each one of the sites where we have our forms and ask our people to do a better job of managing the inventory.

In addition, we've gone back to management and asked management to more carefully supervise the forms to be sure that they are available and that we are replenishing the forms.

Now, Mr. Chairman, I will tell you that from time to time, we do have situations where, because of unanticipated requests for forms, we may be out at a particular site. In that event, our forms distribution sites—the three sites across the country—will give expedited treatment to fill those forms orders.

Chairman PICKLE. In some of the visits that our staff have made to the offices, some of your personnel have indicated that they just generally wait until the supply gets low or out before you order them. And that is inexcusable if that's the case.

Mr. GIBBS. I agree.

Chairman PICKLE. That shouldn't be. Let me ask you one more question here. I notice in respect to late filing, in 1983, 34 percent of the taxpayers filed in April. In 1987, 39 percent.

Now, you've indicated that that number is getting larger; that is, less people are filing early. And indications are that the April peak will be around 40 percent or 41 percent. Now that means that more and more people are filing late.

Why is that?

Mr. GIBBS. We have done several studies to determine that. Based on the studies that we have done, and this actually involves going out and surveying taxpayers, so that we're actually asking the taxpayers——

Chairman PICKLE. Now, that chart you just showed showed your gap is closing. So you're only 9 percent lower?

Mr. GIBBS. No, 6 percent, at the present time, about 6 percent.

Chairman PICKLE. Well, we had testimony earlier that it was 9 percent. But now it's 6 percent.

Mr. GIBBS. Now, it's 6 percent.

Chairman PICKLE. Well, if it's 6 percent, that would be acceptable, would it not?

Mr. GIBBS. It is. And the other thing, Mr. Chairman, that I haven't mentioned previously, we did some surveys earlier this year and found that in a number of instances we had major companies that were running somewhat behind in distributing W-2s and 1099s this year, later than they normally would.

So we think that's yet another reason why, perhaps, taxpayers were filing later.

Chairman PICKLE. Well, practitioners in my area tell me—and I understand this is your figure too—that there are more extensions being asked this year than previously. As a matter of fact they have indicated the situation might be doubled in the area of asking for extensions.

Now, in my own Austin center, I understand that the service center had over 825,000 extensions last year. Now, if they are doubled this year, that means you'd have about 1.6 million extensions.

Now, is my district different, or is that the average across the country?

Mr. GIBBS. Well, as the filing season has grown later, we have seen more extensions. But frankly, Mr. Chairman, the extensions do not cause us problems.

Chairman PICKLE. They do not?

Mr. GIBBS. No, they do not. Because when a taxpayer files an extension, they must nevertheless make a tax computation and send in the tax that they owe.

When they finally file the return with us, that means we spread our workload out, and we process the returns as they come in. So that will not cause us problems.

Where we will have our problems is if there is a crunch at the end of the filing season, at April 15.

Chairman PICKLE. Well, I'm glad it didn't cause you a big problem. But Mr. Commissioner, if extensions don't give you any problems, then you're saying it doesn't matter if they get the forms in by April 15. You don't mean that.

If we have 16 million that are going to be postponed, that's what, 15 percent or thereabouts? Isn't that a large number?

Mr. GIBBS. I don't think that is a problem for us. I think the problem comes in this: I think most taxpayers want to prepare and file their returns by April 15. They want to get it out of the way.

And that's why we are urging people to start earlier this year. You mentioned just a minute ago, for example, the recent articles that have been talking about tax terror. You know, in our Advertising Council campaign we anticipated that folks were going to be concerned.

And you will recall, one of the things that we talked about, and we were intending this as a spoof, was the horror of the tax filing season that people create in their own minds.

So we're not surprised by this kind of rhetoric. The point is that you can eliminate that fear—and this is our message this year—you can really eliminate that problem by filing earlier.

What we're finding is that if taxpayers will get into this, for the overwhelming majority of taxpayers, when they get into the forms, they find that they can cope with them.

Yes, it is going to be more complex and more difficult for some. But for many taxpayers, Mr. Chairman, it is going to be easier.

Chairman PICKLE. Well, let's hope so, Mr. Commissioner. Mr. Schulze?

Mr. SCHULZE. Thank you, Mr. Chairman. Gentlemen, welcome to the subcommittee.

I would like to join the chairman, Larry, in expressing my personal gratitude for your emphasis on service. I believe it is long overdue. I believe from your background, you're aware of what service means to both the practitioner and the individual who's filing his return.

I think it will pay dividends. It may create some problems in the short run. But I think that this trend toward greater service is one that will be beneficial.

Mr. GIBBS. Thank you, Mr. Schulze.

Mr. SCHULZE. What lessons did we learn from the W-4, let's call it an awkward experience, last year? Did we use that as a learning experience? Or did we just say, that was a mistake, and let's go from there?

Mr. GIBBS. We definitely used it as a learning experience.

The thing that I think we learned from the W-4 was that we ought not to make assumptions about what is in the best interests of taxpayers; which I think we did when we said, when all of us said, that it would be better for taxpayers to more closely match their withholding to their tax liability.

Mr. SCHULZE. Have we looked at other forms in a different light now?

Mr. GIBBS. Indeed we have. What we did in the W-4, as you'll recall, in the second form we went back out and we talked to taxpayers. We did focus groups and surveys to find out what problems they were having, what their patterns were in terms of what they wanted withheld.

That's exactly what we did, as I indicated in my opening statement, for our 1040, our 1040A, our 1040EZ, the mortgage interest form, the IRA deduction form, all of those. We went back out before we finalized the printing, used the focus groups, 64 across the country with Booz-Allen, in 23 cities, involving over 550 taxpayers, and we tested those forms to find out where the problems were, what kind of issues were arising with the elderly, with low-income, middle-income, and high-income taxpayers.

And then we went back and made changes in those forms to try to make them easier to prepare. And that is something that we have done again and again and again, not just on the forms, but we did that in a number of other areas where we've actually gone out to find out what taxpayers want and how they feel.

We're doing exit interviews this year in certain areas where taxpayers go into our taxpayer assistance offices. We want to know what kind of service they received and what kind of experience they had. And we're using that information to manage our people and to provide better service.

Mr. SCHULZE. Larry, in 1988 so far, the average refund is about 13 percent higher than it was last year. Does this lead one to conclude that the taxpayers were unable to follow the W–4 properly, or that they over-withheld? Or how do you view that?

Mr. GIBBS. The way I view that, Mr. Schulze, is this. When we made the decision that people wanted to more closely match their withholding to their tax liability, I think we forgot that you really ought to go to the customer and ask the customer.

When we went out with the focus groups, what people told us was, hey look, we realize we're not getting interest on this money. But we do it for a variety of reasons.

For one thing, we don't want to be underpaid in our taxes. Second, since it comes out of our withholding and we don't see it, it is a type of enforced savings.

And I think what you're seeing is that taxpayers, if you'll give them the opportunity, will structure their withholding to do what they want to do; not what the Government wants them to do.

Mr. SCHULZE. So in effect those who deliberately over-withhold would perhaps file early, and this would then explain the 13 percent increase?

Mr. GIBBS. Not necessarily, Mr. Schulze. We have found over the last several years that in relation to the late filing trend—you cannot generalize that it's only going to be the refund returns that are going to come in first.

What we are really concerned about, at the end of the filing season, and where we will have our problems, is if those refund returns come in late, because we have to process those within 45 days to avoid paying interest.

What we are watching very, very carefully are those refund returns.

Mr. SCHULZE. I mean, historically, do the larger refunds occur early?

Mr. GIBBS. Not necessarily; you cannot make that correlation. In short, we are going to be watching, and we will report on a weekly basis. But we think we are really closing the gap.

It is not just refund returns that are coming in.

Mr. SCHULZE. On telephone assistance, I would assume that as the individuals get more experience, their percentage of correct answers will increase.

Is that a correct assumption? Do you have meetings where you say, the 10 most asked questions are, and these are the correct answers, and as a consequence, try to raise that average, and does it work?

Mr. GIBBS. Mr. Schulze, this is the whole point of our program this year. Previously, we have not had a system to be able to identify where the problems were occurring.

We actually have the questions broken down into categories. And let me make this point. I think it's important for you to understand.

The questions we are asking are representative of the questions we are being asked. The way we get those questions is to ask the people in our sites that are monitoring the calls, and then they tell us the types of questions and the areas where the taxpayers are asking us questions.

We monitor these categories, and when we see that there's a problem, we can go back to call sites, even on an overnight basis, saying, look, this is where we're having major problems. Here are the types of things that we need to work on.

Already this year we've called in representatives from each of four sites; agreed from a management standpoint how to address this issue; and we've gone back with remedial training this last week, and we will continue to do that.

Thus, the system gives us constant feedback that we can use as a training technique to improve the quality.

Mr. SCHULZE. What kind of figures should we expect? I'm sure you're not satisfied with 75 or whatever figure we're using. What's your goal? I know your goal is 100 percent. But where could we reasonably expect to be by the end of the filing season?

Mr. GIBBS. Mr. Schulze, the people in private industry have told us: don't set error ranges; don't set tolerances. If you set tolerances, that's where you'll wind up as an organization.

Now we are clearly going to try to exceed last year. But what we're trying to do, you're absolutely right, our goal, and it's a long-range goal, is 100 percent. And where we're going to be headed this year is to see how close we can get to that without establishing an artificial ceiling.

Mr. SCHULZE. I hope you'll keep us apprised of the progress.

Mr. GIBBS. Oh, believe me, we have said to you, we have said to the media, that we are going to be coming out with this on a weekly basis.

That's why I think it is so very important to understand what our system is and why it needs credibility in terms of what we're doing.

Mr. SCHULZE. Mr. Commissioner, in November of 1987 the IRS lost a court case where the taxpayer claimed that the IRS had made an improper disclosure of confidential tax return information.

Now, the IRS admitted that the taxpayer information should not have been disclosed, but the IRS claimed it was not liable because the computer made the mistake. In other words, it's the computer's fault.

The courts held that you were wrong, and you are liable for computer error. I ask this question because I want you to have an opportunity, and I want to ask you whether in the future you're going to point to the computer and say, it's not us, it's the computer.

And let me preface that by saying: We don't want to hear that, and the American people don't want to hear that. They hear it all the time, and they just don't buy it.

Mr. GIBBS. Mr. Schulze, the court was right; we were wrong. Computers don't make errors. People make errors. And it's not just the people.

What we're really finding with our quality improvement system is that it is the system. What I'm saying is, the people are out there trying. It's up to us in management. It's up to us in the organization to work on the errors that are caused by the systems, whether they're computer systems, management systems, or whatever they are.

But it's inappropriate to tell a taxpayer it was a computer problem. It's our problem.

Mr. SCHULZE. I'm glad to hear that. I'm glad that that's your attitude. I appreciate it very much. Thank you.

Chairman PICKLE. Thank you, Mr. Schulze. Mr. Dorgan?

Mr. DORGAN. Mr. Chairman, thank you very much. Commissioner Gibbs, let me emphasize at least somewhat with the Internal Revenue Service.

I understand that you administer laws passed by Congress. And when Congress does what was done with the Tax Reform Act, the sheer scope of those changes, I'm sure, cause some very substantial problems in the development of rules and the drafting of forms, and so forth.

We have had the most significant change in tax law in the 1986 Reform Act that we've had in decades. So I understand the difficulties.

That doesn't make it any less burdensome for taxpayers who are filing the long form and who may be struggling with it. It is probably safe to say that a good many people in this country will have an easier time this year in filing their tax return, because more people will file the short form. So for a good many Americans, this will not be a problem.

But for some who file a long form and who may have to go through several new features on that form, this could be a difficult period for them. That's what I think the questions relate to today.

This morning I noticed on one of the television shows Jane Bryant Quinn giving what I thought was a pretty balanced view of what taxpayers might face.

I read the periodical that the chairman referenced last evening on the airplane. It was Newsweek, with the title, "Tax Terror." And I read it because I was interested in what that title meant, and what they were going to say about the tax system.

And then comparing that to Jane Bryant Quinn, who incidentally writes for the same magazine, comparing her comments to Newsweek last evening was kind of an interesting comparison.

But I'd like to, in any event, ask you about three areas if I might. The first is error resolution. Let's say that I file a long form and go through the agony and the difficulty and get it filed. And I have an error in that form.

The question that I've asked in the past is, if I have a problem in my credit card account—American Express, just to pick a credit card—I get somebody on the line, and they're sitting at a CRT, and they pull up my account, and they can make changes because that account is on line.

Where is the Internal Revenue Service with respect to that kind of system, so that somebody who has an error can at some point in the loop not be communicating with a computer, but in fact communicate with somebody real who sits at a terminal who can pull up the record and make real changes in the record?

Are we there? Are we getting there? What will the taxpayer expect in the years ahead?

Mr. GIBBS. Excellent question, Mr. Dorgan.

We are not there. We are getting there. Let me elaborate.

Our tax system in this country, from the standpoint of the computer, is literally a 1950 system. It's dependent on tape. It's not a real-time system. And we literally have not had the capability in the past to do exactly what you're talking about.

An American Express or a department store—if there is a problem with a customer's account, the person working for the American Express or the department store simply calls up the account, makes the change, puts the change in, and tells the customer it's been corrected.

We have not had that capability to a very large extent. We are beginning to have that capability at our taxpayer service sites. Also, at our automated collection sites.

But that capability will not really be there until we have the tax system redesign that I discussed earlier in place.

We are taking some interim steps. Working with several of the major universities in the country, we have found this last year a way to connect our computer systems.

And we hope within a matter of a year to two years to actually have the capability in our automated collection sites, and hopefully, in our taxpayer assistance sites, to connect the systems.

We have some projects going on in several cities in the country to experiment with different ways of coming close to that at the present time. We have one in Nashville. We have one out in San Francisco. Both are in taxpayer service.

We are making good progress with it. It's going to get better. But we're not where we want to be. We know taxpayers are frustrated. And believe me when I say, we are frustrated with our inability to get there.

Mr. DORGAN. All right, now let me ask you further, let's assume that I'm that taxpayer that filed my return. And there's an error on the return, or something has happened so that the Internal Revenue Service sends me a computer letter saying that we've got an unresolved problem here.

And we get down the road, and I can never quite figure out where I can get hold of a human being here. I keep getting letters back from the computer. I talked to you some days ago about a CPA who called me from Cavalier, ND, that had gotten in this cycle where he just couldn't penetrate it.

He'd write back and say, well, here's what our differences are. And then he'd get another letter from the computer back, not acknowledging the information he'd sent.

And then you're at the point where you're going to attach a bank account or something. So I've got a real horror story on my hands.

How would you as Commissioner advise me to get through to a human being? What kind of procedures do you have set up to intercept what some have referred to in the past as horror stories?

Mr. GIBBS. What we are doing, Mr. Dorgan, and we have given a good deal of publicity over the last 18 months to this, and you're going to be seeing even more, is that we are using our Taxpayer Ombudsman, and our problem resolution offices, to address these kinds of issues.

We have done surveys with the taxpayers and practitioners where they're telling us that our problem resolution program

really does work to resolve these kinds of problems. We've gone out, done the surveys.

And what we're going to do is expand that program, and also the advertising so that people can understand how to use our problem resolution program in a more effective way to address these types of issues.

Mr. DORGAN. Well, I think that's important. Because I think 90 percent of the cases can be resolved by a computer letter that says, here's the mistake in line 8; 90 percent of the cases can get resolved that way between a taxpayer and a communication from the Internal Revenue Service.

But the other 10 percent, or whatever percent it is, may develop into an incredible misunderstanding that a taxpayer simply can't deal with.

They're trying to confront a very large organization that they think at some point is almost inhuman. So to the extent that you can develop systems and procedures that will allow a practitioner or a taxpayer to cut through all of that when they come to a situation they can't seem to resolve and have somebody there that says, okay, let's solve this thing for you, and stop the paperwork back and forth——

Mr. GIBBS. Could I follow up with that?

This really is the thrust of our quality and customer service program as well. I mentioned problem resolution in the context of what you were talking about in terms of the unusual problem that we simply can't seem to get resolved.

Understand that with our quality and customer service efforts, what we are trying to do is to spot the problems in the system that are producing the errors so that we eliminate the errors before they get generated.

What we're asking our people to do, even beyond problem resolution, is to see the taxpayer as a customer. We are trying to address that within the system itself.

Mr. DORGAN. I'd like to ask one further question, if I might, Mr. Chairman.

As you know, Mr. Commissioner, part of a task force recommendation that I and some others put together included a proposal called the IRS Assistance Across America. The reason we felt that was important is I think compliance is directly related to information and assistance that taxpayers out there receive in preparation of their tax returns.

I would like to ask whether you would consider over the coming year working with some of us on the committee to see if we couldn't do a couple of test areas in this country to reverse some of the centralization that's occurred in recent years in taxpayer assistance, and at least in some areas, maybe test market a plan that says, let's put the service back here, and let's move some folks back in a test area perhaps out to the shopping centers, and the malls and so on, and really provide some taxpayer assistance. Let's see what that might do to change the ability of people to comply with and complete correctly their tax returns.

I think the centralization that we've seen occurring in the last decade and a half has not been wholly useful. I understand why it's happened. But I think we ought to consider, at least from the

standpoint of taxpayer assistance, moving Internal Revenue Assistance in selected times of the year back out into the country to see if we can't serve and assist the taxpayers.

That's particularly true now in the event of the 1986 act which changes things and makes things more difficult, at least for some. I'd like you to work with some of us, to at least consider test marketing an idea like that in a couple of areas of the country.

What would your impression be of that?

Mr. GIBBS. I would be delighted to work with you. I'd like to preface it by simply saying, I don't know whether you're aware of this or not, but I'd like to give you some statistics about your own state.

Last year we had one fulltime and two part-time employees in walk-in offices in our Fargo district. This year we have three fulltime, one parttime, and during the filing season, we will have six. That's a total of 10 instead of 3 in our walk-in areas in Fargo.

In Bismarck and Grand Forks, we have expanded this to a full year-round service. Is Minot—M-i-n-o-t?

Mr. DORGAN. It's Minot.

Mr. GIBBS. Minot, OK, has been opened as a part-time year-round service. Dickenson, Williston, Jamestown, Valley City, Devil's Lake, and Wappeton——

Mr. DORGAN. Did you anticipate this question? It's Wappeton.

Mr. GIBBS. Wappeton? Our new offices this year, and they'll be open one day a week.

This is something that our people are doing on a local level in terms of trying to provide better assistance on a walk-in basis to taxpayers this year.

Mr. DORGAN. Well, to many places in America, such as North Dakota, walk-in might be a 100-mile walk. I just traveled to North Dakota yesterday.

I thank you for making some progress. You obviously have some good staff that anticipate some of these questions.

But I would encourage you to work with some of us on a more aggressive test run in some of these areas to see if we might not, on the service area, provide some more resources in a certain approach early in the year, and the result perhaps would be to head off some serious compliance problems later in the year.

I'd be happy to work with you on that. Thank you very much, Commissioner.

Chairman PICKLE. Thank you, Mr. Dorgan.

Commissioner, let me ask you in line with one of the questions Mr. Dorgan had asked, with respect to the automated systems, you're now hooking up among the district offices throughout the nation.

My question to you is in the field of electronic filing. I note that in 1986 we had about 25,000 electronic filings. Then in 1987 we had about 50,000. And I'm told that this year you might have as much as perhaps 500,000. Is that accurate? Is it more than that? Is the trend increasing that much? What can we anticipate?

It seems to me that that brings up a lot of questions down the line about how we'll handle all our district offices and the others. So can you comment on that briefly? Is that the trend? How many do you expect in 1988?

Mr. GIBBS. Mr. Chairman, we are seeing electronic filing really catch on this year. As you pointed out, in 1986 we had a total of 25,000 returns filed electronically. Last year we had 75,000 returns, total, filed electronically.

This year, as of last week, we had almost 120,000 returns in this country filed electronically. We have been projecting somewhere between a half million and a million returns coming in electronically at any one of 16 sites, 16 major areas, across the country.

We have moved out of the testing phase. We have begun operations. Frankly, the reception has been excellent; so excellent that one of the major tax return preparers has had to announce a curtailment of one of their programs because they were having so many people come in to use electronic filing.

We are delighted with this progress. We think this is better service to customers.

Chairman PICKLE. If it increases in such big proportions, is it possible that we would need less personnel?

Mr. GIBBS. Mr. Chairman, remember we're talking 100,000 out of over 107 million individual returns, so we're not there yet. But as we are able to bring this program up, we think it will have some major savings in our service centers.

Chairman PICKLE. All right, thank you.

Mr. MCGRATH. Thank you, Mr. Chairman, and thank you, Commissioner, for coming in and giving us the benefit of your insights on this filing season.

I am pleased, along with my colleagues, to see the advances that have been going on.

We have heard a lot about how complicated this new tax law is. When you readjust the entire Tax Code, you're going to have to expect some complexities.

Let me ask you this question. I'm trying to get a sense of just how complex it is for the average person. How many returns are going to be filed this year, what is your ballpark figure?

Mr. GIBBS. Our ballpark figure is about 108 million individual returns will be filed this year.

Mr. MCGRATH. And how many of those are going to use a standard deduction rather than an itemized deduction?

Mr. GIBBS. We believe this year, if I can recall the numbers, I believe we're talking about some 68 million that will use the long form 1040, and the rest will either be filed on a 1040A or a 1040EZ.

Mr. MCGRATH. OK, so we are talking in the neighborhood of less than half, substantially less, maybe three-quarters, using a standard deduction that is easily decipherable.

Mr. GIBBS. Let me pause for just a second, because I would like to get you a specific answer on that.

[Pause.]

Mr. GIBBS. We are told that 66 percent this year do not have to itemize, and it will be over 70 percent next year.

Mr. MCGRATH. All right. And what does this do? I mean the fact that even though there is confusion among the 20 to 25 percent of those who itemize, or perhaps there may not be, what has this done for the compliance rate?

We have been told over the years that the voluntary compliance rate has gone down because of the complexity and the unfairness

in the system. Maybe we didn't make the tax reform bill less complex, but we tried to be more fair about it.

What has that done in terms of the voluntary compliance rate? Do you have any figures on that at this particular point in time?

Mr. GIBBS. Well, I think, again, we will actually see a diminution in the number of long form 1040s, absolute numbers. We're looking for a drop in the long form 1040s that we'll receive.

And we will see an increase this year, we're estimating, of 4 to 5 million in 1040As and 1040EZs.

Mr. McGrath, the 1040A and the 1040EZ are clearly simpler forms to prepare. Will there be some mistakes on those this year? Yes, there will. But since they are simpler forms to prepare, we are anticipating that that kind of voluntary compliance will be very beneficial to our system, in terms of the 5 million that will, in effect, go to the 1040As or the 1040EZs.

It will not only be easier for them to file; it means they will have better compliance.

Mr. MCGRATH. Let me ask you this question. This may not be of much interest to you, but it was to us when we were drafting the bill. In regards to the withholding, you said something about how we shouldn't tell the taxpayers how to match their withholding to their tax liability.

One of the reasons we did that was to garner enough revenue through estimates so we could continue to lower the rates to the lowest possible denominator. Now by not enforcing to any great extent that provision in the bill which requires you to have 90 percent withholding of your liability, what do you think that's going to do as a revenue impact to our goal of revenue neutrality?

Mr. GIBBS. I don't think it will have any impact on that. And if anything, from what we're seeing this year, in terms of what taxpayers have done, total withholding has gone up.

Total withholding is 3 percent higher this year, and estimated taxes are 13½ percent higher.

Mr. MCGRATH. Well, I understand that, because we mandated that. But if you're saying that we shouldn't be telling the taxpayers how to match their withholding to their liability, it seems to me that somewhere along the line we're going to have a shortfall in revenue, and that's going to put us in a position of not being revenue neutral.

Mr. GIBBS. Mr. McGrath, let me clarify what I said a minute ago. I'm suggesting that if taxpayers had literally followed the W–4 form, the long one that we initially put out, if they had more closely matched their withholding to actual tax liability, if they had done that, then we would have less in the way of withholding than we have actually experienced this last year.

Mr. MCGRATH. Explain that again.

Mr. GIBBS. All right. The thrust of the original W–4 form, in accordance with the congressional reports, was to put out a form that would more closely match what is withheld to tax liability.

Now, I'm saying that if people had literally followed those instructions this last year during 1987 we would have had less withheld than we have actually experienced. And the reason I say that is because the average refund this year so far is up, not down.

Mr. McGRATH. But also it tells me that your instructions for your W-4 form were so confusing as to get that kind of a result.

Mr. GIBBS. Well, what we found out when we went out and focus-tested our more simplified form is that people told us they weren't interested in more closely matching what was withheld to what their tax liability was going to be; they wanted a cushion.

Mr. McGRATH. I see.

Mr. GIBBS. And what I think it tells us is that people were not sure what to do this year, and they added more cushion.

Now, we'll see next year how that plays out.

Mr. McGRATH. What you're saying is that people claim zero so that they get a refund back rather than people like me who claim eight so I get more money in my pocket.

Mr. GIBBS. No, some people do that. Some people want to accurately match withholding to tax liability. That's fine, they can do that. No problem with that.

But there are many people, many more people we've found who fit with the numbers I have been discussing. Some people say that the reason we have refunds, substantial refunds, in this country is that people don't understand. That's not at all what we found out when we went out and did our surveys. People do understand. What we're finding is that for a variety of different reasons people really do want the cushion of the additional withholding to get the refund.

Mr. McGRATH. Last year, when we had all this confusion with the W-4 form, you came and volunteered that there would be no penalty for not filing that form or not adhering to the wishes of the Congress during that time.

How has that worked out, and are you going to continue that position?

Mr. GIBBS. Yes, the way that's worked out, Mr. McGrath. For taxpayers who owe us tax that is attributable to wages, on which there would have been withholding, we will not impose a penalty this year.

Mr. McGRATH. Okay. We made some assumptions. I don't know if you're going to have these figures, but I'd be interested in seeing them. We made some assumptions in income distribution during tax reform that taxpayers in the wage class of zero to $20,000 would have a reduction in their liability of 20 percent from $20,000 to $30,000, it would be around 9 percent; $30,000 to $40,000, 7 percent. It averaged out around 7½ percent, somewhere, and $200,000 and above, it was somewhat lower.

When will we be able to get those figures to see whether or not our assumptions for reduced liability in those wage distribution classes were accurate or not?

Mr. GIBBS. Mr. McGrath, our Statistics of Income Division has put into place ways that we will be able to get that and a great deal of additional information.

As we get through the filing season this year, we will begin taking a preliminary look at that. I will give you a more definitive answer in what I'd like to include in the way of a followup answer for the record.

But believe me, just as soon as we can get that information out later this year, or into next year, depending on how long it takes, we will do that.

I've asked our folks to try to expedite getting that information out, because I think it's important.

Mr. McGRATH. Well, I'm interested because I've heard that in last year's return, in the wage class of $200,000 and above, there were 705,000 tax returns filed. Approximately half received an increase in their liability; approximately half received a decrease in their liability.

It indicates to me that there's been some change in behavior out there. I'm interested in finding out what the behavioral changes would be in the other wage classes in order for us to better tailor our ability to target some of those groups?

Mr. GIBBS. We will have information for you hopefully later this year, but as soon as we can, in that regard.

Mr. McGRATH. Thank you, Commissioner. And thank you, Mr. Chairman.

Chairman PICKLE. Mr. McGrath, let me add this, that the purpose of this hearing this morning primarily is to see how we're handling the filing season for 1988, how we're prepared.

Are we giving proper taxpayer services? Are the district offices handling the work load? And are they making as few errors as possible?

We are not in a position to make an evaluation of the 1986 tax law yet. We will be holding hearings later this year to keep apace with both how we're handling this season, from actual filings, to the mechanics of filing, as well as looking into the substantive questions of what did the 1986 Tax Act really do.

We don't know that, yet. I ask you though, Commissioner, when will you know, at what time during this year, whether the 1986 Tax Act quote, has worked? Whether it was the proper approach?

In other words, will you know by this fall whether we have raised enough money to run our Government?

Mr. GIBBS. Mr. Pickle, I think from the standpoint of what we are already seeing in the way of withholding receipts and so forth, I think from the standpoint of funding with respect to this new act, there is no indication at all that there's any basis for concern in terms of producing the money, that type of thing.

So from a funding standpoint, again, I think the returns, if not already in, I don't see at least any basis for any concern there.

Chairman PICKLE. All America is waiting and anxiously wondering whether it is the proper approach and how it will come out. And we all have to be confident that it will.

But we will need to have that information as soon as we could.

Mr. GIBBS. And could I comment on one thing in that regard?

Chairman PICKLE. Yes.

Mr. GIBBS. I think it's very important to steer clear of generalization in this area. I'm not naive. I read a lot. I can certainly see that there are broad concerns being expressed.

But I think it is important to take a look at the specifics, instead of reacting simply to broad concerns about whether something is too complex, too difficult; whether it's good or bad in general.

What I think we really need to do is to get back to specifics. I think we ought not to mistake the confusion, because of change and some of the complexities out there, we ought not to mistake that for the obfuscation of some who would take confusion in general for their personal benefit or gain.

And I think it's important as we begin to analyze this new act that we take a look at specifics.

Chairman PICKLE. Well, Mr. Commissioner, we are not generalizing anything now. But these answers must have come out sometime during these hearings.

Mr. GIBBS. That was not directed at you, Mr. Chairman, or the subcommittee.

Chairman PICKLE. I understand that.

Mr. GIBBS. I'm saying that what we're hearing in the rhetoric in the public today, if we get back to specifics, we can deal with those, if there are specific forms or that type of thing. But the general idea that there is complexity or concern, that is very difficult to deal with.

Chairman PICKLE. Well, we're not generalizing now. The facts must speak for themselves sometime toward the latter part of this year, and we are all anxious to see how it actually develops.

Now, Mr. Jacobs, the Chair recognizes you.

Mr. JACOBS. Commissioner Gibbs, on the first point which I gather from what the chairman says is the point of this oversight hearing, I will say for the record I like the way you're doing your job. You're knowledgeable, and what is more important, you've been reasonable, I think, in your dealings with the Congress and your dealings with the American public.

That stands us in good stead, I think, with the storms you've already endured and the ones that are ahead.

On the second point, there may be some confusion in some people's minds about the effect of the 1986 act, but there didn't seem to be much confusion in the mind of columnist Kevin Phillips who was quoted in Business Week in 1986 as saying, it is a program to put two Mercedes in front of every house in Darien, and sooner or later, everybody else is going to realize it.

So when I hear my colleague over here from New York say that those over $200,000 are down to about a 7-percent tax cut, I have to be curious.

And I recall that in the 1981 act, I believe, our first family had about $25,000 a year knocked off their personal taxes. And that's the one everybody admitted was a tax cut. And of this one, our computer tells us the first family has another $49,000 knocked off. And this is the one they don't admit is a tax cut for the people on top.

That would sound to me like more than a 7 percent cut for Mr. and Mrs. Reagan, for example. And what a 28 percent does for a man like Iacocca, going from the 50 percent rate of earned income to 28 percent, is something that boggles my mind.

Would you have any idea, do you know anything about his $20 million income, and where the loopholes leave off and where the stratosphere begins, where it is pure, old fashioned, gurgling, gravy, to go from a 50 percent rate down to 28 percent?

Mr. GIBBS. Mr. Jacobs, I don't. No, I'm personally pleased that 2.8 million taxpayers at the low income level will no longer be taxpayers or even have to file returns this year.

I'm particularly pleased with the 7 million that we no longer have to itemize. I'm frankly delighted as a tax administrator that the passive loss rules have had the intended impact and we are no longer seeing tax shelters.

As we get into the figures, and the figures will be available—you can draw your own conclusions. But I'm saying again, I think it's important to go to specifics with respect to this act and to keep things in balance as we take a look at it.

Mr. JACOBS. Well, I'm mad at myself for asking that question. I think I know the answer to it, but I like you too well. You're doing a good job with what you have to work with. Thank you.

Chairman PICKLE. Mr. Anthony, do you have any questions?

Mr. ANTHONY. Thank you, Mr. Chairman. Commissioner Gibbs, I'd also like to say I think you're doing a good job. It's a tough, difficult task.

I want to share with you a recent conversation I had with some CPAs. I was in the home State of Mr. Jacobs, Indiana, over the weekend.

These CPAs told me that although we had lowered the effective tax rate that they were still ascertaining that there was a great deal of interest by their clients wanting to fudge—they used a little bit stronger word.

That bothers me. I wonder if in your early feedback from your agents or from any of your early returns if you are determining whether or not we have stemmed the tide of people wanting to cheat, overstate deductions, understate income at the time we have tried to lower the rates by getting rid of all of or as many of the loopholes as possible in preferences. What are you seeing there?

Mr. GIBBS. We are watching that pretty carefully, Mr. Anthony. As the returns come in this year, we are doing two things: One is we're taking a close look at a fairly large sample of the returns to try to determine first where taxpayers appear to be making honest errors and then feed that back.

But the other thing that we are doing is to take a hard look, and this is part of our compliance program under this new act, to see where people are likely playing games with the returns this year.

I am not going to broadcast all of the things that we have found. I will tell you this, we find taxpayers making sort of an interesting use of schedule C this year with respect to moving items that haven't previously appeared on that schedule relating to a business, investments, that type of thing.

That is one of the places that we are going to be looking at in particular, I think, as we begin our compliance program under this new law.

So, we are well-aware of the need to continue to monitor returns. I don't want to overstate it. Most of the errors that we are seeing really are honest errors that are coming in.

Mr. ANTHONY. I guess what would disturb me though, is if a lot of people with lower incomes felt that there were too many Iaccocas and they're going to get theirs one way or the other.

The way that they would get theirs would be by overstating and under reporting. Then instead of having a revenue neutral bill in the next year or two, we could have a—we could have a situation where there was—would be an enormous revenue drain and I think that would put us back to taking a whole look at the circumstances.

So, I was just passing on some information from the field from some accountants who are already having their clients come in and are making a request to maybe do something that they haven't done in the past.

And with them giving them some good, friendly advice and saying, "Hey, come on, you don't need to do that. Let's just play it this way."

Mr. GIBBS. Thank you, Mr. Anthony, I appreciate that. And let me assure you that while we are trying to give better service to people who are trying to comply, we will not hesitate to use the compliance tools that we have to go after those folks who are not interested in complying.

Mr. ANTHONY. I yield back the balance of my time, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Anthony. Now, Commissioner, let me jump to a question about the communications replacement system.

In 1985, we had a horrible year, embarrassing for everybody and aggravating to the American public when we had neither proper functioning front end processors or main frames.

Now we have set about to correct that and I think we must look into the future. You have indicated that it is no problem.

Now, as I understand it, you have put in new main frames in all of the IRS centers. Is that correct? Is that done all throughout the country, the main frame computers?

Mr. GIBBS. Mr. Chairman, I'm going to ask Mr. Capozzoli, in charge of our computer services, to join us at the table if he can.

What we have done, this last year, is to put in two new front end processors, one in Fresno and one in Austin, but—

Chairman PICKLE. I understand that there are only two front end processors, but I am starting off now backing up first on the main frame. Are all the centers equipped with new main frame computers?

Mr. GIBBS. Since 1985?

Mr. CAPOZZOLI. Since 1985, yes, Mr. Chairman.

Chairman PICKLE. Would you identify yourself.

Mr. CAPOZZOLI. I am Assistant Commissioner Dan Capozzoli.

Chairman PICKLE. All right. Now, what was your answer?

Mr. CAPOZZOLI. Yes, we do have our main frames in all our service centers from 1985. We have now increased those computers in all our service centers.

Chairman PICKLE. All right, now, we only have two front-end processors, one in California and one in Texas. And you have, what, 10 centers?

Mr. CAPOZZOLI. That is correct, Mr. Chairman.

Chairman PICKLE. And you've got eight more. Will those eight other centers have front-end processors by this year?

Mr. GIBBS. We are looking to have them in. I will ask Mr. Capozzoli to comment on this, but the way things are going, we would anticipate having the front-end processors for the remaining centers by this time next year, perhaps even late in 1988.

Chairman PICKLE. All right. Now, why is it so slow? Since 1985 we knew that the front-end processor was the weak link in our systems and we set about to correct it. Now, this is 1988.

Now, you are telling me that you hope that you will get them in by the end of this year. Why the delay?

Mr. GIBBS. The delays have been caused for several reasons. We had some procurement and contract problems early on with our front-end processors. If you will recall, we discussed this during this hearing last year.

We also had some problems because the subcontractors had not performed in a way that they should have performed with respect to those.

We worked that out and as GAO testified last year, the thing that they urged us to do, as we were trying to put the front-end processors in, was to be sure that they would work and work properly as we put them in.

That is what we have been doing this last year.

We are having excellent results with those in Fresno and in Austin. We will continue to take the same approach. Get them in as quickly as possible, but not put them in until we are sure they will work.

Chairman PICKLE. Now, nobody wants you to rush into them where they would not be properly installed. Is there a problem getting equipment or is there a problem with installation?

Mr. CAPOZZOLI. Right now, Mr. Chairman, the problem is just getting them all tested out. Once we start our process—it's going to take us between now and the end of this year to get them all in. It just takes time to implement those systems.

Mr. GIBBS. That will be about a 1 year lag from what we thought originally.

Chairman PICKLE. Let's assume that you get them in by the end of this year or by this time in 1989. That means that all centers would then have the new front-end processor with the old main frames.

How long will the present main frames carry the load of our tax system? As I understand it, GAO will testify later this morning that it might last us until 1991 or 1992 in that area. Is that correct or do you challenge that?

Mr. GIBBS. Mr. Chairman, what I'd like to suggest is this and, again, I am looking forward to sticking around for the GAO testimony and will be delighted to have the dialog with them. I understand what we are talking about is this: You will recall last year at this time we testified that we thought we were going to be able to come up with ways to extend our present computers from the standpoint of finding additional capacity.

At that time, we were forming a group to take a look at what were then only ideas. Over this last year, we have actually come up with concrete approaches in order to be able to do that, to extend the existing capacity of our computers.

If I recall correctly, and I will ask Mr. Capozzoli to comment on this in a minute, we have completed our review and we have indicated to the GAO that when it is convenient with them we would like to be able to review our specific findings and recommendations to extend that capacity until 1994.

My understanding is that that will take about 30 days for them to take a look at what we have concluded already. In addition, Mr. Chairman, some additional equipment will be installed in the early phases of our redesign initiative that could be in place before 1994.

Now, between those two we hope, Mr. Chairman, to be able to close that gap. And I'm hopeful that what we and GAO will agree upon today is that as soon as they have an opportunity to review what we have already done, then you can have some assurance with respect to whether we have, in fact, closed the gap.

Chairman PICKLE. Well, Commissioner, I'm trying to look down the road to see if we are going to be able to avoid the horror stories we had to endure during the 1985 season.

Now, if we only got two front end processors in the service centers now, after 3 years of planning, nearly 3 years of planning, and it is going to take another year to get them in place.

I am wondering then will that system, coupled with the main frame operation, be sufficient to meet the IRS computer needs until you get the new tax redesign system in place. I do not know that it will.

In the meantime, will you need to be ordering new main frame computers to get ready? I am disturbed because the GAO tells us, and you will hear from them, and I want you all to stay around now to hear their testimony, that this present system is probably going to be inadequate or obsolete by about 1991–92.

Now, you give me this discussion that you want for them to understand what you are doing. You don't believe that big a gap exists. You say you have got enough capacity to last until 1995 or 1996.

Now, either one or the other of you is wrong, and I just have to say we've got to look down the road. I want to know if you are satisfied that we've got the right kind of equipment, that it will be in place, in order, and well maintained so that we won't have to go through another embarrassing season like we did in 1985.

Mr. GIBBS. As best we can tell at this point, Mr. Chairman, yes, I am. And, again, I will wait until we get to the GAO testimony but I am not sure that you will find in the final analysis that there is that kind of disagreement.

Chairman PICKLE. Well, are you planning, in the meantime, to actually acquire any additional computer systems, hardware?

Mr. GIBBS. That is certainly an alternative. We have taken a look at that alternative but we are concerned with two things: one, the cost of doing that and, secondly, the energy and diversion of attention that that would require.

We are not suggesting that at the present time. But we think that there is still time, if that should be necessary, to adopt that as a strategy later on. At this time, no, we are not recommending that.

Chairman PICKLE. All right, that is a matter of record, then. Mr. Anthony, do you have any other questions?

Mr. SCHULZE. Just briefly, Mr. Chairman. Mr. Commissioner, one of the other members talked to you about problem resolution and the ombudsmen. Let me say from my personal experience with constituents and with practitioners it has been excellent.

I hope I can say that in the future, but as of right now, the response has been very good. They have found the problem resolution officers accessible and with the ability to solve problems on the spot.

I think it's marvelous and I hope that it continues. I hope I can say that in the future. If not, I'm not going to say it. But right now our experience is excellent, especially with the Philadelphia region and, so, I hope it continues.

Now, I want to talk to you about filing and compliance and forms on the taxpayer assistance program.

When a taxpayer calls on the phone or walks in, is he requested or required to give his name?

Mr. GIBBS. Well, if he is calling on the telephone and asking us to send information to him or her——

Mr. SCHULZE. Yes, I would say you would need it then. But otherwise, if he's just calling up with a question, does the individual he's talking to say, "I need your name"?

Mr. GIBBS. Our employee is to identify himself or herself, but we do not ask the taxpayer to do so.

Mr. SCHULZE. That was my next question. Does the IRS employee give his real name, does he give a number, does he give a code name? How does that work?

Mr. GIBBS. The IRS employee is requested to give his or her real name. Just introduce themselves on the telephone, say who it is.

Mr. SCHULZE. You made the statement before the Senate committee the other day that if there is an error due to an employee giving information to the best of his ability, and the taxpayer relies on that information, that you are not going to come down on him with both feet.

You are going to say, "Look, we understand this. It may not be right, but here is what we have to do to resolve this problem."

And, so, I am trying to understand if that comes up whether there are ground rules, whether an individual should say, "I would like to have your name," and make a note of the individual with whom he spoke or the date or time, that is whether there are any ground rules.

I think it is very good of you to do that, but I want to smooth things in advance if we can.

Mr. GIBBS. Mr. Schulze, I was a little surprised with the reaction to that. I have my attorney here with me. I will let him speak for himself, but I would be astounded if we would go into the courthouse where we believe that a taxpayer had credible evidence that the taxpayer had called us or relied upon information that we had given and we were attempting to impose a penalty.

I think that that's a decision that would be made if the evidence were credible so that the taxpayer would not have to try the case. And if that is, in fact, the case, then we ought not to be imposing the penalty in the administrative process.

Now, you quite properly focus on the same issue that I raised in the Senate and that is how do you discharge the burden of proof if

you are the taxpayer to indicate that, in fact, you did get the information and attempted to rely on it.

We are, in fact, developing some guidelines that I hope to be publishing shortly to give that kind of guidance to taxpayers out there. And we will provide it to you and the other subcommittee members at the time we do so.

Mr. SCHULZE. Great, I would appreciate that.

Mr. GIBBS. Mr. Nelson, do you have anything to add to that?

Mr. NELSON. I agree with my client that we would not take those cases to court and we would not pursue them.

Mr. SCHULZE. Mr. Commissioner, when Booz-Allen conducted focus group interviews last year to test the 1040, 1040A, and 1040EZ, schedule A, the IRA contribution forms and home mortgage interest forms, I would presume they came up with a list of potential errors or potential problems from these interviews.

Are those lists that they gave to you turning out to be true, first? Or, secondly, were there changes made as a result of those recommendations. And, if so, have they precluded problems or preempted problems that might have arisen?

Mr. GIBBS. The Booz-Allen report has been made public, in terms of all of the analysis that they did. It is in the public domain.

I honestly do not recall the extent to which they got into our forms, but it would be in that report and if you would like we will review it and put something in for the record.

Let me tell you, however, about our experience with the mortgage interest form. There are about, we estimate, 27 million people in the country that will claim a home mortgage interest deduction this year. When we first prepared our initial drafts of the form, a substantial number of those people would have had to fill out the form. As a result of focus testing and also discussions with practioners, we began to revise the form in an attempt to eliminate as many people as possible off of that form.

As a result of those efforts, we went through several drafts—and we estimate, again, based on information that we gathered from the private sector, that less than 1 percent of the taxpayers, less than a million taxpayers will actually have to complete that form.

That was done as a result of the testing and the input we got from Booz-Allen.

Mr. SCHULZE. That's good. That is the kind of information I was looking for. If you will give me the figures on whether they made recommendations which were followed or were not followed and whether they turned out to have been problem areas.

The reason I want this information is so that if it is, if it would have been beneficial, then we want to do more of that in the future.

Mr. GIBBS. I can and—let me go to that. I thought you were talking about the Booz-Allen report in terms of our readiness.

What you are really talking about are the Booz-Allen surveys that they conducted for us, the focus groups.

Yes, we have that information. We will make it available.

I do not recall a single suggestion or recommendation that they made that we did not take, but I will make that information available to you.

Mr. SCHULZE. Thank you, Mr. Commissioner, thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Schulze. Now, Commissioner, we have two other witnesses to appear before us and I hope that you and the other Assistant Commissioners can stay to hear GAO make their report on both their taxpayer service review and their analysis of the equipment that might or might not be needed.

Now, let me try to put this in perspective. I am little bit disturbed that we hear from the press, from the national media, from some of the reports that our staff people have made as they went into the field in five different offices, from listening to the GAO report, as well as your own, that there is confusion out there about filing these returns.

You tell us that that is not so, that you are in control, that you are in good shape, and the number of mix-ups would be very small.

I am trying to reconcile the great differences between, say, a magazine like Newsweek, which comes out this week and says it is an IRS taxpayer's horror year and your rosy picture.

I am going to assume that you are in better possession of the facts, and I want to believe you. And I know personally from the people in my district office there in Austin that your people give good service and are trying to stay right on top of things.

Now, the fact of the matter is when 25 percent of your call-in answers are incorrect, that is an admission that we have got a great improvement to make.

When you say there will be an increase of 5.5 million errors this year, though you cut it back to say it might not be more than 3.2, that is an enormous amount.

When we have added 25 percent new personnel or phones in the telephone system, and still there is only 75 to 80 percent of the calls being answered in the first call, that is a matter of real concern.

When we go into these offices and in five different offices we find that they were insufficient in having some of the forms needed, then we have to ask ourselves why in the world do we have a delay in getting sufficient forms printed? And some of the people in your offices said, "Well, we really don't have an inventory policy in place. We just kind of wait to see if they're getting low and then we order them." If that is the fact, and I do not make that accusation, then that is not acceptable. We cannot accept that.

There seem to be questions in your mind, as between GAO, whether we really will have sufficient main frame computers on line.

Now, these are just some of the things that bother me in between what you have said and what seems to be the facts that are being produced by Booz-Allen, produced by the GAO and by some of our national publications.

So, I think it is something that we have got to stay abreast of here.

Now, in the other body, you testified that you would be thrilled if the Congress would give you more money for taxpayer services.

Well, we gave you about $58 million more as I recall it last year. And the budget this year is up very little. You said, what—you are shaking your head.

We did give extra money for it. As a matter of fact, getting money for IRS was a hard thing. We had to pull teeth in the last 2 or 3 years to make IRS take enough funds to handle it.

Now, we have put in additional funds, because we recognize that these problems must be addressed, and I think we are doing it. And I think you are doing a good job down there. So, what I am saying is not critical. But I do not want to leave the impression created by your testimony that everything is smooth, that we are in perfect control and that we do not have any problems.

It seems to me that we ought to admit that when we make the biggest tax change in 40 years, with over 2,000 different alterations, and change the structural system, that we are going to have great difficulty.

So, I am just hoping that, between what you have said, and what I hear, the facts will be that we are on top of things. That remains to be seen. It will be interesting for us to have another hearing on this between now and the end of the filing season, or as we go along through the year.

We are going to do this not to be critical, but so that we and the public will know what is the status of things and what is really correct.

So, I am not swallowing everything you have said as the gospel. I want to believe it. And I commend you for the efforts. You have really worked hard to anticipate the public's questions.

But because of the vast changes, I think the jury is still out on this whole situation. So, we will have to watch it. That is why we are going to hold some hearings as we go along through the year.

Now, I tried to make that kind of summation from my own feeling. Do you want to respond to that in any way?

Mr. GIBBS. Yes, I would, Mr. Chairman. If I have given you the impression that I think that there will be no problems or that there are no problems this year, then I have not conveyed to you how I feel.

I have said from the beginning that when you have one of the largest tax acts that we have ever had in this country, you are going to have problems. That is not really the issue.

The issue, I think, is how are we doing in terms of tax implementation as a whole.

You are absolutely right on taxpayer service. I am not satisfied with three out of four. That needs to get better. You are absolutely right that it is unacceptable in any office for us not to order forms until we are out.

Beyond those two items, absolutely I will say that there are some folks out there that are finding it more difficult.

I think it is absolutely clear that the tax practitioners are having a very difficult time, because they deal, Mr. Chairman, with the wealthier taxpayers that have the more sophisticated tax situations. And they have to learn all the rules.

But I also submit that their clients are the minority and not the majority in this country. And, again, putting it in context, I'm simply saying that as we talk about the difficulties, let's talk about specifics.

Let's talk about specifically who is having what problems and what kind of problems they are and address it in the specifics.

Because for many taxpayers in this country, as I have tried to point out this morning, they are going to have an easier time.

They are not going to have to itemize. They can prepare the returns if they will get started. All I am trying to do is balance it out and present an overall balanced picture. That is really where I am coming from.

And if I have given the impression that it is all sweetness and light, that is incorrect.

But what I am saying is overall, for my overall assessment, I think we have prepared very well for this filing season.

I think the returns are coming in. I think the refunds are up and we have got a system in place to address the shortcomings in the taxpayer assistance and also in our forms area.

That is really where I am coming from in terms of my message this morning.

Chairman PICKLE. Well, I am satisfied that you all are making your best efforts in this field and it is a Herculean task right now with these big changes.

But, we too must watch it closely, and we will be looking at this as we go along.

So, I thank you now. Will you be able to stay, you and Mr. Murphy?

Mr. GIBBS. Yes, sir.

Chairman PICKLE. Because I want you to hear what GAO has to say, and we may have additional questions for you.

Mr. GIBBS. Fine.

Chairman PICKLE. Thank you.

Mr. GIBBS. Mr. Schulze, thank you.

STATEMENT OF JENNIE S. STATHIS, ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Chairman PICKLE. Jennie Stathis, Director of the General Government Division of the GAO is our next witness. And Mr. James R. Watts, Associate Director, Information Management and Technology Division of the GAO.

Both of you are now at the witness table and we will ask Jennie Stathis if you will proceed first.

Ms. STATHIS. Thank you. Good morning, Mr. Chairman. I am pleased to be here today to assist in your review of the 1988 filing season.

I would like to summarize my statement and submit the full statement for the record.

Chairman PICKLE. Without objection, the statement of Ms. Stathis will be placed in the record.

Ms. STATHIS. I believe you have a copy of the summary that I will be using.

Chairman PICKLE. Are you going to be using your summary as the base?

Ms. STATHIS. That is correct.

Chairman PICKLE. You may proceed.

Ms. STATHIS. As you and others have been saying this morning, the 1988 filing season is the first in which IRS and taxpayers must implement many of the changes in the Tax Reform Act of 1986.

That act, the most sweeping tax legislation in three decades, changed 2,000 subsections of the Internal Revenue Code and necessitated changes in over 200 forms and instructions.

Thus, IRS was faced with the monumental task of preparing both taxpayers and its own employees in a short period of time.

My testimony makes six points. Under the circumstances, IRS did a good job in trying to prepare its employees and the tax paying public for the 1988 filing season.

IRS hired and trained staff earlier than in past years, embarked on an extensive media campaign, tested new forms for clarity, made readiness checks at each of its 10 service centers and used alternative formats such as announcements and notices to provide early guidance.

Second, telephone assistance has been meeting taxpayer demand in terms of quantity. But preliminary results of test calls by IRS and us indicate that IRS assisters need to improve the accuracy of their responses to taxpayer questions.

Our preliminary test call results, which are not projectable, indicate that IRS is answering 62 percent of the questions accurately. IRS' own preliminary test call results indicate a 75 percent accuracy rate.

Third, our preliminary survey at six walk-in offices indicated a high level of taxpayer satisfaction with IRS service.

Eighty-four percent of the 423 individuals we surveyed were satisfied or very satisfied with the usefulness of the assistance that IRS had provided them.

Fourth, some forms and publications have been unavailable to taxpayers at certain walk-in distribution sites. Some of the forms and publications, such as those on individual retirement arrangements, are of particular interest this filing season.

Of the mail and telephone requests for forms and publications, IRS statistics showed that about 98 percent have been filled.

Fifth, although members of the tax practitioner community were pleased with IRS attempts to provide early written guidance, they had mixed views on the adequacy of the regulations IRS has issued.

They believed that the lack of some guidance and the complexity in others are causing problems for both taxpayers and IRS.

And then the last point in the statement is that at this early point in the filing season, returns processing is proceeding smoothly and service center inventories are at levels that IRS considers manageable.

Despite the IRS intensive campaign to encourage taxpayers to file earlier this year, the trend in recent years towards filing later appears to be continuing.

IRS has established various mechanisms to identify and correct problems that surface during the filing season.

We plan to continue to monitor the effectiveness of those actions through the remainder of the filing season.

This concludes my summation, Mr. Chairman. After my colleague presents his statement, I will be happy to try to answer your questions.

[The prepared statement follows:]

United States General Accounting Office

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Status of the 1988 Tax Return Filing Season

Statement of
Jennie S. Stathis, Associate Director
General Government Division

Before the
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

GAO/T-GGD-88-13

87-154 0 - 88 - 3

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in its inquiry into the status of the 1988 tax filing season. Our work is in response to requests from your Subcommittee; the Joint Committee on Taxation; and the House Government Operations Subcommittee on Commerce, Consumer and Monetary Affairs.

The 1988 filing season is the first in which IRS and taxpayers must implement many of the changes in the Tax Reform Act of 1986. That Act, the most sweeping tax legislation in three decades, changed 2,000 subsections of the Internal Revenue Code and necessitated changes in over 200 forms and instructions. Thus, IRS was faced with the monumental task of preparing both taxpayers and its own employees in a short period of time.

My testimony makes six points:

-- First, under the circumstances, we believe IRS did a good job in trying to prepare its employees and the taxpaying public for the 1988 filing season.

-- Second, telephone assistance has been meeting taxpayer demand in terms of quantity. But preliminary results of test calls by IRS and us indicate that IRS assistors need to improve the accuracy of their responses to taxpayer questions.

-- Third, our preliminary survey at walk-in offices indicates a high level of satisfaction with IRS service.

-- Fourth, some forms and publications have been unavailable to taxpayers at certain walk-in distribution sites. Of the mail and telephone requests for forms and publications, IRS statistics show that about 98 percent have been filled.

-- Fifth, members of the tax practitioner community have mixed views on the adequacy of written guidance IRS has issued to help taxpayers and practitioners interpret the Tax Reform Act of 1986. They believe that the lack of some guidance and the complexity of other guidance are causing problems for both taxpayers and IRS.

-- Sixth, at this early point in the filing season, returns processing is proceeding smoothly and service center inventories are at levels that IRS considers manageable.

IRS' EFFORTS TO IMPLEMENT THE TAX REFORM ACT OF 1986 AND PREPARE FOR THE 1988 FILING SEASON

Overall, we believe IRS did a commendable job in trying to do all that had to be done in a short period of time to implement tax reform and in trying to anticipate what might happen during the 1988 filing season. IRS developed a strategy that sought not only to assure timely actions in implementing more than 2,000 section changes to the Internal Revenue Code but also to prepare the public and its own staff for the impact tax reform would have on preparing 1987 returns and processing them in 1988. In so doing, IRS did more than ever before to prepare for the filing season.

In reviewing IRS' efforts, we looked at forms development, taxpayer service, employee training, service center readiness, and written guidance provided taxpayers.

In the area of forms development, IRS tried to minimize the complexity of the 162 revised forms and 48 new forms by releasing most of them for public comment and by pretesting some, such as the 1040 series, using focus groups. Despite IRS' efforts, some forms remain complex. For example, tax practitioners point to the form to compute deductible home mortgage interest, which was

released last summer for public comment and pretested using focus groups. Tax practitioners had mixed views as to whether the form could have been any simpler.

To better inform the public, IRS sent flyers to about 94 million taxpayers describing some tax reform-related changes and offering a new publication which explains in more detail the effects of the 1986 Act. The mail-order demand for that publication reached about 11 million as of February 6, 1988. IRS also conducted nationwide teleconferences with preparers to explain changes and answer questions. Currently, IRS, with the assistance of the Ad Council, is conducting an extensive media campaign urging people to file early.

Also in the area of taxpayer service, IRS made a concerted effort to hire and train staff early and have them prepared for the filing season. IRS hired about 1,000 more telephone assistors than last year and installed about 900 more telephone lines. Classroom training for assistors was provided earlier than ever before and the assistors were kept on board for extensive on-the-job training. In past years, assistors were trained and then furloughed until the filing season began. Although some districts had problems hiring assistors early, most were able to hire the necessary number of staff by the start of the filing season, putting IRS in a more advantageous position, from an on-board staffing perspective, than in past years.

IRS took similar steps to prepare service centers for the 1988 filing season. It hired and trained returns processing staff early with an eye towards being fully prepared to process returns at the start of the filing season. All centers reached their filing season hiring objectives. In addition, IRS performed readiness checks at each center and developed contingency plans to address unexpected filing patterns, unacceptable processing delays, or inventory backlogs. Among other things, contingency plans include steps to shift service center staff to functions where problems develop. We are now monitoring returns processing and, should it become necessary, will see whether the contingency plans work as intended.

In addition to contingency plans and readiness checks, National Office teams visited all 10 service centers during 1987 to brief management on the anticipated impact of tax reform on the filing season, what to expect, and how to deal with it. IRS is projecting an overall net increase of 3.7 million tax returns for the 1988 filing season, a 3.6 percent increase over 1987, and a net increase of 3.2 million errors on filed returns.

In the area of written guidance, IRS used various formats, such as announcements, notices, and revenue rulings, to explain tax law changes and new filing requirements. As of February 11, 1988, some guidance had been issued on 66 of the 76 sections of the Act that IRS identified as high priority.

I will now discuss what has happened during the filing season to date.

TAXPAYER SERVICE AT
CALL SITES

Most taxpayers who seek help from IRS in preparing their returns do so via the telephone. As of February 13, IRS statistics show that the 32 call sites had answered about 7.2 million telephone calls from taxpayers seeking answers to tax law questions. That volume is 9.8 percent more than last year but 10.9 percent less than IRS had anticipated.

Although weekly patterns vary, IRS' statistics indicate that call sites cumulatively have met about 84 percent of the demand for

telephone service, which is only slightly below IRS' objective of 85 percent.

To assess the quality of the telephone service and to identify areas where telephone assistors may need help, IRS headquarters personnel have been making calls using 41 test questions since January and will continue to do so through the filing season. According to IRS results on about 5,000 of 20,000 planned calls, 74.8 percent of the calls were answered correctly. That percentage was composed of 61 percent that were answered correctly and completely and another 13 percent that were answered correctly but not completely. The remaining 25 percent were answered incorrectly.

We have just begun our own assessment of IRS' accuracy and accessibility in answering 20 tax law questions. Our preliminary results, based on 224 calls over 6 days, show that we are receiving correct responses to about 61 percent of our calls: 57 percent completely and 4 percent not completely. The remaining 39 percent were answered incorrectly. Seventy-seven percent of the time we were able to reach an assistor on the first try. The rate increased to 93 percent within 5 tries. Because these results are based on only 13 percent of the total calls we intend to make and are unweighted, they are very preliminary and not projectable at this time.

Managers and assistors at five call sites told us that many taxpayer questions are related to tax reform changes, such as those involving home mortgage interest deductions, dependency rules, and individual retirement arrangements. We observed that call site managers are reviewing assistor responses for accuracy and completeness and have mechanisms in place to identify questions or issues giving assistors problems. IRS officials are providing feedback, guidance and/or additional training to assistors on problem issues.

TAXPAYER SURVEY AT IRS WALK-IN OFFICES

We recently started an assessment of IRS' walk-in taxpayer service. On 3 days this month, we surveyed 423 taxpayers who visited walk-in offices in Washington, D.C.; Wheaton, Maryland; Detroit, Michigan; Livonia, Michigan; Seattle, Washington; and Portland, Oregon. We plan to survey taxpayers again in March and April.

Our preliminary survey results indicate that taxpayers were generally pleased with the service IRS provided. More specifically

-- 84 percent of the respondents were either generally satisfied or very satisfied with the usefulness of the assistance the IRS walk-in office provided,

-- 81 percent were generally satisfied or very satisfied with the clarity of the information provided,

-- 74 percent were assisted within 15 minutes of arriving at the office,

-- 82 percent were generally satisfied or very satisfied with the amount of time it took to get assistance, and

-- 95 percent were generally satisfied or very satisfied with the courtesy of IRS' assistors.

Less than 7 percent of our respondents indicated dissatisfaction in any of the above aspects of IRS' walk-in service.

Asked whether preparing their tax return this year was easier, harder, or about the same as last year

-- 45 percent of the 423 taxpayers said it was harder or much harder,

-- 32 percent said it was about the same, and

-- 13 percent said it was easier or much easier this year.

About 10 percent of our respondents indicated that they were not sure yet how difficult preparing their returns would be.

DISTRIBUTION OF FORMS AND PUBLICATIONS

In light of IRS' efforts to encourage taxpayers to file early, it is important that necessary forms and publications are readily available. Taxpayers can either obtain those documents in person at walk-in distribution sites or order them by mail or phone.

Using an IRS list of 233 forms and publications, we measured the availability of those documents at six walk-in distribution sites in six districts. Availability varied from site to site. For example, at two sites which receive forms and publications from the same central source, one site did not have 41 forms and publications while the other site was missing 11. Because of space limitations, some walk-in sites may not be able to stock all 233 forms and publications. Some of the out-of-stock documents, however, such as those relating to the submission of information returns, were included on IRS-prepared lists of forms and publications that the walk-in sites should stock. The out-of-stock documents also included publications on issues, such as individual retirement arrangements and business use of the home, that would seem to be of interest to many taxpayers.

According to the director of one of the three national distribution centers that provide forms and publications to the walk-in sites, orders from sites are often placed after the site has exhausted its supply. This creates a temporary shortage in particular forms or publications. Persons in charge of the walk-in locations, who are responsible for reordering, told us that the unavailability of forms and publications at the walk-in locations creates anxiety and frustration on the part of taxpayers. Such frustration could detract from the effectiveness of IRS' promotional efforts to file early.

Taxpayers can also order forms and publications by mail or phone. Those orders are filled by one of the national distribution centers. IRS statistics indicate that as of February 13, 1988, the centers had filled about 98 percent of the 4.8 million mail and telephone requests for forms and publications. According to IRS officials, the distribution centers normally process those orders within 24 to 48 hours of receipt. As of February 13, there were 51,900 backorders for forms and publications in reprint status, which is down about 40 percent from the previous week.

INTERPRETATIVE GUIDANCE

IRS has made progress in meeting its plan for providing written guidance on the 1986 Act. That plan centered around IRS' identification of 76 sections of the Act that required priority attention. By February 11, after dropping 2 sections from the priority list, IRS had issued partial guidance on 66 sections. However, IRS was behind schedule on 26 sections, having issued no guidance on 8 of them, and delayed its target completion dates for another 22 priority sections.

Tax practitioners we contacted had mixed views on IRS guidance. Usually they characterized IRS' original implementation plan as

realistic. Some felt that issued guidance was generally adequate while others criticized the lack of detail in some regulations. They all expressed concern with the lack of specific guidance on passive activity rules, which was one of the areas that IRS had targeted for early guidance. Practitioners predicted that the lack of early guidance on passive activities as well as the inherent complexity and newness of other issues, such as reporting mortgage interest, filing returns for children, and calculating travel and entertainment expenses, could result in increased errors on returns and taxpayer requests for filing extensions.

RETURNS PROCESSING
AT IRS SERVICE CENTERS

Although it is still early in the filing season, IRS statistics and our work at 4 of 10 IRS service centers indicate that the processing of tax returns is progressing smoothly and that the service centers are maintaining their correspondence and error inventories at levels that IRS considers manageable.

Despite IRS' intensive campaign to encourage taxpayers to file earlier this year, the trend in recent years towards filing later appears to be continuing. As of February 12, 1988, IRS had received about 17.0 million individual tax returns and issued about 1.7 million refunds. These figures are down 9.7 percent and 11.6 percent, respectively, from the same period in 1987. Although IRS had projected that taxpayers might file their tax returns later in 1988 because of the need to adjust to tax law changes, the actual number of returns filed still falls about 5.5 percent below projections. If this pattern continues, the volume of filings around April 15 could be heavier than IRS anticipated and could trigger contingency plans to prevent delays in processing refunds and depositing remittances.

In preparing for the 1988 filing season, IRS made a concerted effort to reduce service center inventories to their lowest level in several years. These include such inventories as correspondence from taxpayers and errors on tax returns that must be corrected before a return can be processed. IRS had projected that taxpayer correspondence and errors might increase substantially in 1988 as taxpayers and IRS personnel reacted to changes in tax forms and filing requirements. As of February 13, IRS service centers reported that these inventories remain at levels that IRS considers manageable.

Although the error inventories reported by service centers as of February 13, 1988, were lower than at the same time last year, IRS officials noted several areas where taxpayers are making frequent errors:

-- Taxpayers are not selecting the correct standard deduction for their marital and/or age category.

-- Filers of Form 1040EZ returns are not indicating on line 4 whether they can be claimed as a dependent on another person's return.

-- Filers of Form 1040 are incorrectly claiming total miscellaneous deductions on Schedule A when they should only be claiming those deductions that exceed 2 percent of their adjusted gross income.

IRS is alerting taxpayers and tax preparers to these problems through press releases and newsletters. It hopes thereby to reduce the number of similar errors from taxpayers who file later. IRS is also identifying processing errors made by service center staff and feeding that information back to them to improve their performance.

CONCLUSION

Overall, IRS did well in its initial efforts to implement tax reform and prepare for the 1988 filing season. Despite its efforts, however, implementing a new law as extensive as the 1986 Act is apt to create some confusion and complexity for IRS and taxpayers. Consequently, individuals in the tax practitioner community are expressing concerns about complexity and uncertainties, IRS assistors are not answering all questions accurately, and taxpayers are likely to make more errors on their returns. Although IRS' and our statistics are very preliminary, they indicate the need for IRS to improve the accuracy of telephone assistor responses to assure that returns are completed accurately and processed timely. Walk-in sites must order forms and publications in a timely manner so they are readily available to taxpayers who want to file early, as IRS is encouraging. As noted in our statement, IRS has established various mechanisms to identify and correct problems, such as assistor responses to taxpayer questions. We will monitor the effectiveness of IRS' actions as we continue to monitor the remainder of the filing season.

This concludes my prepared statement. We will be pleased to respond to any questions.

Chairman PICKLE. Thank you very much, Ms. Stathis.

STATEMENT OF JAMES R. WATTS, ASSOCIATE DIRECTOR, INFORMATION MANAGEMENT AND TECHNOLOGY DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. WATTS. Mr. Chairman, and members of the subcommittee, I, too, am pleased to be here today to discuss several issues regarding IRS's computer systems.

I also would ask to have my statement entered into the record and I will briefly synopsize various portions of it, going through the testimony with you.

Chairman PICKLE. Without objection, the statement of Mr. Watts will be placed in the record.

Mr. WATTS. Briefly, we believe IRS's computer resources should be sufficient for this filing season. Acceptance testing of the communications processors is progressing satisfactorily.

The redesign project is progressing, but critical tasks remain to be done. And, a computer capacity gap could occur during 1992, but IRS is developing contingency plans for this possibility.

Let me turn first to 1988. In general, we found that IRS has modified and tested the software necessary to accommodate the Tax Reform Act revisions that go into effect this filing season.

To date, the service centers have not reported any major software problems. We also believe IRS should have computer capacity to support the 1988 filing season.

With respect to automation and this filing season, use of electronic filing is expanding this year. As of February 12, over 96,000 individual tax returns had already been transmitted and processed by IRS.

Last year only 78,000 were processed electronically for the entire year. Basically, then, 1988, in our opinion, looks okay.

But let's talk also about the communications processors, at the bottom of Page 2.

These processors are the computers through which IRS employees, using computer terminals, access information on the large main frame computers.

Existing processors are old and are operating at or near capacity.

Chairman PICKLE. Could you say that again?

Mr. WATTS. The old——

Chairman PICKLE. Operating at capacity.

Mr. WATTS. The old front-end processors, the ones that are being replaced.

Chairman PICKLE. Fine.

Mr. WATTS. To correct this situation, IRS awarded a $150 million contract in February of 1986 to replace these processors.

The new processors are installed in the Fresno Service Center and are undergoing final acceptance testing in a production environment.

Based upon our on-site observations in January, the system was working well and encountering only a few problems. The acid test will occur later this year when the workload going through the new processors is normally the highest.

Because the new system has not yet completed acceptance testing, IRS will have to continue using the old ones to carry it through the 1988 processing year.

They, in our opinion, should be satisfactory during the year, because IRS and the vendor responsible for those processors are providing increased attention to the maintenance of the old equipment.

Now, let me turn to the future and the tax system design program. This program, initiated in 1982, did encounter some delays in the early years of the project.

The early efforts suffered because the approach for developing the redesign strategy changed several times and the initial strategies were challenged as not be redesign and not tied clearly to mission needs.

IRS has taken action in two general areas to avoid a recurrence of these delays. First, it has brought increased top management attention and better accountability to the redesign effort.

Management attention increased in 1984 when day to day management of the project was elevated to the Assistant Commissioner level.

Responsibility and accountability above the Assistant Commissioner level was improved as a result of an August 1987 IRS-wide reorganization which established a new Deputy Commissioner for Planning and Resources.

Among other things, he has senior management responsibility for all of IRS's technology programs.

Second, over the last year, IRS has been taking steps to better define the preliminary design of the system and a general strategy for getting there.

From a design standpoint, IRS is proceeding to describe its automation requirements at three levels. These include large corporate data bases of information generally needed throughout IRS; departmental data bases, generally needed only within one department; and, automation support for specific local office needs.

From a strategy standpoint, IRS has decided to implement these levels of automation incrementally over the years, using a two-phased approach.

The first phase is generally referred to as an interim architecture. It is scheduled to be completed by the 1993–94 time frame.

The second phase is generally called the target architecture and is expected to be completed by 1998.

While IRS is making progress, it must complete many other key actions to validate the preliminary design concept before selecting a final design to implement.

These include finishing its requirements analyses, completing a project plan for integrating the departmental and corporate data bases, identifying alternative architectures, and analyzing the cost and benefits of each alternative.

The completion of these critical tasks should provide a basis for assessing the total cost, the time requirements and the technical viability of IRS's preliminary design concept and its strategies for carrying out the redesign program. And IRS expects to complete these efforts in 1988 and 1989.

Let me move on briefly to a related issue, the capacity gap. In February 1987, we testified before you that IRS should have sufficient capacity to handle its needs through mid-1991, if it carried out several initiatives to extend the useful lives of its computers.

This was about a year or two short of where the tax system redesign was planned to provide new computers and redesign software. Hence, the term "capacity gap."

The preliminary results of our updated analysis of capacity at the three largest centers suggest that the main frames will begin to experience capacity limitations some time in 1992, assuming that IRS's improvement initiatives achieve their intended results.

IRS has made progress on some of these initiatives, but not on others.

Last year's workload grew at about six percent rather than ten. Also, according to IRS statistics, software improvements have resulted in reduced time needed for weekend processing, which has been a critical bottleneck in the past.

IRS intends to redistribute workload among the service centers beginning in 1989 and completing the project by 1991.

It has scheduled a small scale redistribution for 1989. This will not affect two of the larger centers which could benefit the most from this initiative.

Our analysis shows that the useful life of the main frames at the large centers can be extended about a year or so if workload is redistributed.

IRS is currently formalizing its plans for making further redistributions in 1990 and 1991.

Now, while our analyses suggests that the main frames could extend into the 1992 time frame, IRS believes they can last through 1994.

This difference can be attributed almost entirely to the IRS's assumption that certain workload now processed on the weekends can be offloaded and processed on the main frames during the week.

We did not adopt this assumption in our analysis, because IRS has not yet identified the extent to which such workload can, in fact, be offloaded and processed during the week.

IRS has agreed to make such an analysis and we will review it as part of our ongoing evaluation of IRS main frame computers.

Nonetheless to insure IRS has sufficient capacity in the early 1990's, IRS officials advised us that they are also planning, as part of the redesign program, to install additional computers in the service centers 1 to 2 years earlier than previously planned.

These will be used to support not only some redesign initiatives but also some of the workload now processed on the current main frames if it is needed.

IRS plans to complete its requirements analysis for these new computers in a few months.

In summary, Mr. Chairman, in the near term, IRS's computer resources are prepared for the 1988 filing season and progress is being made in testing and installing the new communications processors.

For the longer term, progress is also being made on the tax system redesign project, but considerable additional analysis is nec-

essary to validate the preliminary design concept and the redesign strategy.

In the meantime, IRS has made progress in extending the useful lives of the main frames, but a potential for a capacity gap still exists in the early 1990's if IRS does not implement all of its improvement initiatives.

Even though IRS does not believe capacity will be a problem in 1994, it is developing a contingency plan to provide additional capacity earlier if it is needed.

In our opinion IRS faces a major challenge in maintaining its old data processing systems to accommodate tax law changes and serve the public while also undertaking the monumental task of redesigning this tax processing system to take advantage of state of the art technology.

Meeting this challenge successfully will take continued top management commitment and involvement together with well thought out plans and strategies.

This concludes my statement, Mr. Chairman, and I will be pleased to answer questions.

[The prepared statement follows:]

United States General Accounting Office

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Computer Support for Tax Processing Needs Continuing IRS Attention

Statement of
James R. Watts, Associate Director
Information Management and
Technology Division

Before the
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

GAO/T-IMTEC-88-1

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the ability of IRS' computer systems to handle this filing season's workload, its progress in installing new communications processors and redesigning its automated tax processing systems, and its actions to ensure adequate computer capacity for future filing seasons. Based on our on-going work we found that

-- computer resources should be sufficient for this filing season;

-- acceptance testing of the communications processors is progressing satisfactorily and nationwide installation is expected by January 1989;

-- the redesign project is progressing but critical tasks remain to be done; and

-- a computer capacity gap could occur during 1992, but IRS is developing contingency plans for this eventuality.

COMPUTER SYSTEMS SHOULD BE SUFFICIENT FOR 1988

In general, we found that IRS has modified and tested the software necessary to accommodate the Tax Reform Act revisions that go into effect this filing season. To date, the service centers have not reported any major software problems affecting the processing of 1987 tax returns.

We believe IRS should have sufficient computer capacity to support the 1988 filing season if this year's workload does not increase by more than 10 percent over last year's -- IRS' goal for ensuring sufficient capacity. This looks realistic based on last year's growth of about 6 percent. However, whether tax reform will significantly alter the mix or level of the 1988 workload is unknown at this time.

With respect to automation and the filing season, the use of electronic filing is expanding this year. Electronic filing -- now in its third year -- allows taxpayers to submit their tax returns electronically through professional taxpreparers rather than in paper form. As of February 12, over 96,000 individual tax returns had already been transmitted electronically and processed by IRS; last year only 78,000 returns were processed electronically for the entire tax year. IRS expects to process up to a million returns from individuals electronically this year.

COMMUNICATIONS REPLACEMENT SYSTEM

The communications processors are the computers through which IRS employees, using computer terminals, access information on large mainframe computers to correct errors in tax returns and answer taxpayers inquiries. The existing processors are old, have experienced periods of downtime, and are operating at or near capacity. To correct this situation, IRS awarded a $150 million contract in February 1986 to have these processors replaced with new processors which are more reliable and have greater capacity (referred to as the Communications Replacement System). The new processors are installed in the Fresno Service Center and are undergoing final acceptance testing in a production environment. Based on our on-site observations in January 1988 the system was working well and encountering only a few problems. The "acid" test will occur later this year when the workload going through the new processors is normally the highest. The new system is also being installed at the Austin Service Center and is to be completed by

March. Installation in all service centers is to be completed by January 1989.

Because the new system has not yet completed acceptance testing, IRS will have to continue using the old communications processors to carry it through the 1988 processing year. They should be able to perform satisfactorily based on our analysis of their performance during 1987. Even though the processors experienced short periods of downtime in 1987, these instances did not significantly affect IRS operations. The downtime was not extensive because IRS and the vendor responsible for the processors gave increased attention to the maintenance of the old equipment.

TAX SYSTEM REDESIGN

IRS initiated the Tax System Redesign program in 1982 and encountered a number of delays in the early years of the project. The early efforts suffered because the approach for developing a redesign strategy changed several times and the initial strategies were challenged as not being a redesign and not tied clearly to the mission needs of IRS.

IRS has taken action in two general areas to avoid a recurrence of these delays. First, it has brought increased top management attention and better accountability to the redesign effort. Management attention increased in October 1984, when day-to-day management of the project was elevated to a newly established Assistant Commissioner for Tax System Redesign. Later, in January 1987, IRS made this office the focal point for introducing new technology and for ensuring compatibility among existing and future systems. Responsibility and accountability above the Assistant Commissioner level was improved as a result of an August 1987 IRS-wide reorganization which established a new Deputy Commissioner for Planning and Resources. Among other things, he has senior management responsibility for all of IRS' technology programs.

Secondly, over the last year IRS has been taking steps to better define the preliminary design concept of the system and a general strategy for getting there. From a design standpoint, IRS is proceeding to describe its automation requirements at three levels. These include (1) large corporate data bases of information needed generally by most functional areas throughout IRS, (2) departmental data bases needed generally by only one functional area such as collections or examinations, and (3) systems to provide automated support for specific local office needs.

From a strategy standpoint, IRS has decided to implement these levels of automation incrementally using a two-phased approach. The first phase, generally referred to as the interim architecture, is scheduled to be completed by 1993-1994. The second phase, generally called the target architecture, is expected to be completed by 1998. Primary initiatives for the interim architecture are increased electronic filing, on-line inquiry directly into the master files for selected taxpayer information, and prototyping and development of departmental systems. Primary initiatives for the target architecture include installation of a telecommunication network and redesign of the masterfiles to provide not only on-line inquiry but also update of taxpayer information.

IRS has documented this preliminary design concept and strategy in a management plan and is developing an acquisition strategy. The management plan is being reviewed by senior IRS officials; decisions on approving major sections of the plan are expected by the end of this month.

While IRS is making progress, it must complete many other key actions to validate its preliminary design concept before selecting a design to implement. These include finishing its requirements analysis, completing a project plan for integrating departmental systems and corporate data bases, identifying alternative architectures, analyzing the cost/benefits of each alternative, and completing its acquisition strategy. Completion of these critical tasks should provide a basis for assessing the total costs, time requirements, and technical viability of IRS' preliminary design concept and its strategies for carrying out the redesign program. IRS expects to complete these efforts in 1988 and 1989.

THE CAPACITY GAP

In February 1987 we testified before you[1] that IRS should have sufficient computer capacity to handle its needs through mid-1991 if it carried out several initiatives for extending the useful lives of its mainframe computers. This was about a year or two short of when the Tax System Redesign was planned to provide new computers and redesigned software; hence, the term "capacity gap." These initiatives included holding workload growth to 10 percent a year, improving the efficiency of software used for processing taxpayer information, and spreading the workload more evenly among IRS' 10 service centers. The preliminary results of our updated analysis of computer capacity at the three largest service centers suggest that the mainframes will begin to experience capacity limitations sometime in 1992, assuming that IRS' capacity improvement initiatives achieve their intended results.

IRS has made progress on some of these initiatives, but not on others. Last year's workload grew at about 6 percent rather than 10 percent. Also, according to IRS statistics, the software improvement initiative has resulted in a reduction in the amount of time needed for weekend processing, which has been a critical bottleneck in the past.

IRS intends to redistribute workload among the service centers beginning in 1989 and completing the project by 1991. IRS has scheduled a small scale redistribution for 1989. This will not affect two of the larger centers, which could benefit the most from this initiative. Our analysis shows that the useful life of the mainframes at the large centers can be extended about a year or so if workload is redistributed. IRS is currently formalizing its plans for making redistributions among the service centers in 1990 and 1991.

While our analysis suggests that the mainframes could be extended into 1992, IRS believes they can last through 1994. This difference can be attributed almost entirely to IRS' assumption that certain workload now processed on the week-ends can be offloaded and processed on the mainframes during the week. We did not adopt this assumption because IRS has not yet identified the extent to which such workload can be offloaded and processed during the week. IRS has agreed to make such an analysis and we will review it as part of our on-going evaluation of IRS' utilization of the mainframe computers.

To ensure IRS has sufficient capacity in the early 1990's, IRS officials advised us that they are also planning, as part of the Tax System Redesign program, to install additional computers in the service centers 1 to 2 years earlier than previously planned. These will be used to support not only some redesign initiatives

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[1]Statement of James Watts, Associate Director, to the Subcommittee on Oversight, House Committee on Ways and Means (GAO/T-IMTEC-87-1, February 6, 1987)

but also some of the workload now processed on the current mainframes. IRS plans to complete its requirement analysis for these new service center computers in a few months.

In summary, Mr. Chairman, in the near term IRS' computer resources are prepared for the 1988 filing season and progress is being made in testing and installing the new Communications Replacement System. For the longer term, progress is also being made on the Tax System Redesign project, but considerable additional analysis of requirements and evaluation of detailed design alternatives are necessary to validate the preliminary design concept and the redesign strategy. In the meantime, IRS has made some progress in extending the useful lives of its mainframes, but a potential capacity gap still exists for the early 1990s or sooner if IRS does not implement all of its improvement initiatives. Even though IRS does not believe capacity will be a problem until 1994, it is developing a contingency plan to provide additional computer capacity earlier if it is needed.

In our opinion IRS faces a major challenge in maintaining its old data processing systems to accommodate tax law changes and serve the public while also undertaking the monumental task of redesigning its tax processing system to take advantage of state-of-the-art technology. Meeting this challenge successfully will take continued top management commitment and involvement together with well thought out plans and strategies.

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This concludes my prepared statement. We will be pleased to respond to any questions.

Chairman PICKLE. I want to thank you, Mr. Watts. Now, let me first ask Ms. Stathis, did your people, the GAO, find that the individuals in the IRS district offices were well-trained and qualified to answer the questions that would be called in to them?

Ms. STATHIS. We found in reveiwing IRS's preparation for the filing season that all the people had been trained more extensively this year than ever before.

Chairman PICKLE. Well, the people on the telephones, are they seasonal workers most of them?

Ms. STATHIS. Most of them are seasonal workers.

Chairman PICKLE. Well, wouldn't that on the surface raise some kind of a flag that there would be a problem there if they're seasonal workers? They might not be familiar from month-to-month or year-to-year what the changes are. Particularly this big change.

I guess IRS has a problem that they cannot put their GS–15, GS–14, GS–13's on these phones, because they would be needed in other areas.

And if most of the workers are seasonal, then you're wondering if they're adequately trained. I guess the answer would be that it would be ideal if we could keep these seasonal employees as regular employees.

But you're saying that they're trained, but it's a problem, because they are not that current on the changes.

Ms. STATHIS. Well, one of the things, of course, that happens this year is with hiring 1,000 additional telephone assisters and replacing some of those who did not return from last year, IRS has a lot of telephone assisters who are new this year. They provided a great deal more training for those people this year than they did in the past.

They tried to hire those people earlier and give them more training.

Chairman PICKLE. That's good.

Ms. STATHIS. Keep them on rather than furlough them as they had in the past so that they could provide more on-the-job training.

Chairman PICKLE. What was the accuracy rate of these telephone assisters, according to GAO survey?

Ms. STATHIS. In GAO's survey, 57 percent of our questions were answered correctly and completely. Four percent were answered correctly, but not completely, for a total correct percentage of 61 percent.

Chairman PICKLE. That is 61 as compared to 75 on the IRS?

Ms. STATHIS. That's correct.

Chairman PICKLE. That's a considerable spread. And if your 61 percent—that would be 40 percent of the time calls were made, they were getting incorrect or not complete information. And that is very disturbing, of course.

Now, did you find that there was any variance between districts?

Ms. STATHIS. Our work at this point, Mr. Chairman, is really too preliminary to give differences between call sites. As a matter of fact, our survey is not designed to do that even at the end.

The 2,000 calls we're making are not enough to compare call sites with one another. That is the primary reason IRS has increased the sample size to 20,000, so that they will be able to compare various sites.

Chairman PICKLE. What could the Internal Revenue Service do to improve their accuracy rate?

Ms. STATHIS. You realize, of course, that IRS is asking 41 questions, GAO is asking 20 questions and only 4 of them are the same. So, there are some differences in what we are asking when we make these calls. That, in and of itself, would produce some differences in the results.

In asking our questions, we pose as taxpayers. We try to put together a scenario of what our income is, what our situation is. Some of that information we give the assisters. Some of it we save. We wait for the assister to prompt us to give them that information.

We do that thinking that that is what an ordinary taxpayer would do, that they would not realize that some of that information is pertinent to the answer they're seeking.

Sometimes we get a general answer from the assisters, but they don't ask us enough questions about our particular circumstance in order to know that the answer they're giving us is really not appropriate for our income level or for our particular circumstance.

So, the IRS assisters need to be prompted again to be sure that they get all of the pertinent information from the taxpayer who's calling.

Chairman PICKLE. You've been visiting, GAO, these offices, off and on for the last 10 years, one way or another. Do you detect that there's more training going on now, that there's more sensitivity to taxpayer services and the answers they give?

Ms. STATHIS. That's correct. More training was provided this year than ever before.

Chairman PICKLE. With respect to the forms that were not available, we found specific evidences in our own visits and in your visits where the forms were not available in the district office.

Is the failure to implement adequate inventory procedure because of the delays in printing these forms?

Ms. STATHIS. It is our impression at the moment, Mr. Chairman, that inventory procedures are at fault. We will be continuing our survey to see if anything more can be done.

Chairman PICKLE. Are you saying, in effect, that the IRS really does not have any inventory system in place for these forms?

Ms. STATHIS. It is my understanding that IRS sends out a routine automatic supply of certain common forms every so often during the filing season.

But it is left up to the manager of each walk-in forms distribution site to see that the supply of other forms is maintained.

Chairman PICKLE. If forms are ordered, how quickly are those forms made available?

Ms. STATHIS. Sometimes, if they order them on an emergency basis, saying that they are out of them at the time they are ordering them, the Forms Distribution Center will send them on overnight express mail. So, they are able to get them very quickly.

Chairman PICKLE. Well, now, the Internal Revenue Service has said in their testimony that they got information or forms out within 48 hours. And I think, one or two seasons ago, it must have been 3 or 4 days. But at any rate, they said they get them out within 48 hours.

In some of the calls made by our people and others, perhaps you, the people in the IRS district offices who were receiving the calls for forms said, "Don't expect them for seven or eight days."

Now, if it is a 7 or 8 day delay—and the impression from IRS is that you will have them within 48 hours—I am not making an accusation. The impression would be that they would have those in 48 hours.

And actually it must be 7, 8 to 10 days before the forms are actually received.

Ms. STATHIS. My impression of that number is that IRS will process your order and get it mailed out of the IRS Forms Center within 48 hours.

You then have to consider whatever time it takes for the mail to get to you.

Chairman PICKLE. Well, what I am trying to find out is, is it the Postal Service or the IRS or a combination. If it takes 7 or 8 days, and probably in many instances 10 days, to get those forms, and the person—millions of them will be making the call around April the 1st or April the 5th—that means they won't get the forms in time to send them back in. Is there any way to speed that up?

Ms. STATHIS. You can ask Mr. Gibbs, but I doubt that there is much in the way-—

Chairman PICKLE. The answer is just to file earlier then.

Ms. STATHIS. I think people at least are going to have to have their forms earlier.

Chairman PICKLE. Well, I want to come back to Mr. Watts, but let me recognize Mr. Schulze at this point and then we will return.

Mr. SCHULZE. Thank you, Mr. Chairman. I will be brief. Ms. Stathis, I would like you to be a little more explicit on your phone calls and questions.

If an individual gives you a correct answer based on the information they have received, but they haven't asked sufficient questions, do you count that as correct or incorrect?

Ms. STATHIS. It depends on the way the scenario is set up. For example, one of the questions has to do with a scholarship.

As you know, that was changed in the 1986 Act. If we call and ask, "Do I have to report my scholarship on my tax return," and the assister does not ask for any more information, we would count the answer as incorrect whether they told us yes or no.

We would consider the answer incorrect because the assister would not know whether part of that scholarship was for room and board or whether we received the scholarship after the August 1986 date.

Mr. SCHULZE. Now, did you break down the instances in which the further questions were asked versus those where the response was given based on that information?

Ms. STATHIS. We will have that information. I do not have it with me at the moment.

Mr. SCHULZE. I would be interested in having that when it is complete.

Ms. STATHIS. We usually provide that in our report each time we have completed the survey at the end of the filing season.

Mr. SCHULZE. In your testimony, you discussed late filing and that it seems to be increasing. Do you have any recommendations

for us or for the IRS on what you would do to assist in earlier filing or reverse the trend toward late filing?

Ms. STATHIS. My understanding from different people I talk to is a lot of the delay is caused by taxpayers not having all the information that they need, such as the 1099's that come from payors. This year I understand there was a delay in some large employers getting out their W-2's.

Now days there's more and more of that type of information that's necessary in order to do your return.

So, if there is any way that we can encourage people who provide that kind of information to do it earlier, the returns in all likelihood will be filed a little earlier.

Mr. SCHULZE. Thank you. Mr. Watts, one question. You discussed the so-called capacity gap.

Mr. WATTS. Yes, sir.

Mr. SCHULZE. If you were in Mr. Gibbs' seat, what would you do about the so-called capacity gap. What action would you take today?

Mr. WATTS. Well, I think, first of all, we're talking about a gap that's forecast to occur in the mid-1990's. I would be——

Mr. SCHULZE. Let me rephrase that. Are there actions you would take which are not now being taken? I understand you said they have contingency plans and so forth. Are there things, based on your experience, you would do that they are not doing?

Mr. WATTS. I think they are trying to do the right thing today and it's important that they, as we have recommended in the past, do a good capacity analysis.

Now, as I indicated in my testimony, there are some differences of opinion as to the effect of some of those initiatives. And it is important for them to continue to monitor them.

But recognizing that there is a potential capacity gap out in the future, then IRS needs to set out strategies for adding additional capacity if that is necessary. IRS has been talking to us about the possibility of putting in some additional capacity earlier than they had originally planned.

The idea here, I think, is to look to the future and anticipate problems and to the extent you can lay out plans to address them. I think they are trying to do that.

Mr. SCHULZE. So, in effect, there are no radical things that you would do if you were in that position that they are not doing.

Mr. WATTS. Not today, no.

Mr. SCHULZE. Thank you. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Watts, how confident are you that the IRS can meet its own schedule in the tax redesign system?

Mr. WATTS. That schedule includes about doing things incrementally between here and out to 1998. At this point in time, it is very difficult to say how realistic that time frame is.

As I said in my testimony, there are about five or six major things that they have to do over the next year or so that will give a better handle on exactly how much this is going to cost and what the time is really going to be.

They've done preliminary designs of the system, but now they need to look at alternatives, cost benefit them and then look at the

practicality of them. And then once you get that done then you can get a better idea of the time frame.

If I had to answer the question today, doing it in 8, 10, 12 years, is probably what it's going to require, because we are talking about a massive effort by IRS. We are talking about 10 major computer centers, plus 2 other ones that have to be changed. We are talking about massive files that are stored on several hundred thousand reels of tape that have to be changed.

So, there are a lot of those things that have to be done and it will take time to do it. So, I cannot give you good dates, but I don't look at the 8 to 12 years as unrealistic.

Chairman PICKLE. Well, I am not trying to get you to make a positive Sears and Roebuck guaranteed statement. I am trying to get something out of you, whether you think—are you confident that the IRS will meet their own schedule that they set.

And I take it from your response that since so many things have to be considered that we better get into this system earlier than we are doing at this point. Am I incorrect in my interpretation?

Mr. WATTS. I think they are getting into it now. They are doing the right things, okay. But not until they get these right things done, initially, are we going to have a good handle on how much time it is going to take and what the cost is going to be.

Chairman PICKLE. What impact would a delay cause in this redesign system on, say, the main frame operations?

Mr. WATTS. Well, if there is a further delay, then we have a real capacity gap problem. The more delay, the worse it is going to be.

Chairman PICKLE. So, you are saying we must not have a further delay. We must maintain an agreed on schedule and be addressing it now.

Mr. WATTS. I think we need to get it going, no question about that, but I do not want to put the pressure on to do it wrong.

Chairman PICKLE. Well, of course not, and I didn't ask that question.

Mr. WATTS. Okay.

Chairman PICKLE. You say we should get started on it. Nobody recommended that we do it wrong. Are you saying to go slow?

Mr. WATTS. No, I'm saying go through it methodically and plan it out properly and I think that is what they're trying to do today.

My point is that there are a lot of things they have to do in those plans yet before people can make a good judgment as to how much time and effort it's going to take.

Chairman PICKLE. Well, let me reframe it. Has the IRS developed a concrete proposal for a tax redesign system?

Mr. WATTS. They have identified what I would call a preliminary design. And that is a good proposal, okay, in the general sense. But they have to go in and look at how you're going to implement that.

Chairman PICKLE. They haven't designed one then, but they have a preliminary design?

Mr. WATTS. Yes.

Chairman PICKLE. Let me restate it in terms of—I hope we might understand a little better. We had a great crisis in 1985 because the front end processors couldn't feed material into the main frames.

Now, we spent nearly 3 years trying to straighten out the front-end processors and after nearly 3 years we have only two front-end processors in place now. And we are hoping that in 1988 we might get the rest of them or some time in early 1989.

Now, that means a full 3 years just trying to put in place a front-end processor that would be used in connection with main frames that were put in earlier.

So, if we have those systems in place, and we have been struggling for 3 years just to get the front-end processors, doesn't it stand to reason that you just cannot expect to put in a new tax redesign system over night.

Mr. WATTS. Absolutely.

Chairman PICKLE. Therefore, any expression of waiting until, say, 1994 or thereabouts to get into this process might be too late.

Am I to understand that you are saying they ought to start on this thing soon to have a system in place, or can they wait until the 1990's to get into it?

Mr. WATTS. I think we have to look at it as an incremental process. They are going to be adding things each year.

Let me give you an example of that. I commented about electronic filing in my testimony today—it is a part of the redesign effort. It is ongoing on a pilot basis. Actually, it is more than a pilot today. It is a key element of the redesign program. There are other things they are doing today to develop the redesigned system.

But the acquisition strategies have to be put in place to bring on the additional computers. They intend to get that done in 1993 and 1994. If they progress as they seem to be progressing right now, that looks like a realistic date.

Chairman PICKLE. Well, is the process of installing front-end processors in place now?

Mr. WATTS. The front-end processors are installed in two of the service centers. It seems to be working well. They expect to get front-end processors installed in all service centers by January of 1989.

Based upon the experience that they have had, what they have learned from this, that looks like a realistic date.

Chairman PICKLE. Well, what I am specifically asking in the first place is, has the GAO in your survey identified any problem in the IRS computer operations that will adversely impact this year's filing system?

Mr. WATTS. From what we've seen in terms of the software and today's capacity, I would say not. The only risk area I would identify are the old front-end processors and I think that they've got a good handle on them.

Chairman PICKLE. I am sorry. I didn't hear that last part.

Mr. WATTS. I think the only risk area they have to keep on top of are the old front-end processors, and I think they are on top of that, and they can manage that risk. So, I don't see a problem here.

Chairman PICKLE. Do we have contingency equipment on hand?

Mr. WATTS. Yes. There is contingency equipment on hand to handle any down time, if they need additional parts or replacements, but you can't make those old ones——

Chairman PICKLE. Do you anticipate or are you aware of any remaining problems in the installation of the front-end processors?

Mr. WATTS. There is only one minor dispute that I am aware of between IRS and the contractor; that pertains to the level of documentation to be delivered by the contractor.

In my opinion, I think IRS needs to stay to it and demand the level of documentation they are asking for. But that is a minor problem at this point in time from what I can tell.

Chairman PICKLE. Then it is GAO's testimony that the IRS has only tentatively identified a tax redesign system, that you are not concerned that they will not implement it in time, and that everything is in order. And we, the Congress, should not have any concerns about the equipment.

Mr. WATTS. I think we should have concerns about the equipment in terms of 1992 timeframe. As I testified, I think that that is a potential problem area.

Where I am concerned is whether or not they are going to have the tax system redesign done on time. They cannot give you a really good date, nor can I until they do additional work.

With this additional work we will all have a better idea of exactly what the redesign is going to be and the strategy that they are going to follow.

I cannot give you a good date. Nor can they, in my opinion, tell you how realistic that 1993–94 timeframe is.

Chairman PICKLE. Commissioner Gibbs is still here. Commissioner, do you want to respond? I see you fidgeting around back there. [Laughter.]

And we would be pleased for you to make any response to their observation.

Mr. GIBBS. I think the most significant point that has been made on the redesign of the tax system and the capacity issue is that this is an incremental process.

Again, you have to get back to specifics. And what you have to take a look at is, given the timeframe that we spelled out and what we told you previously, are we on track with where we said we would be?

This time last year, Mr. Chairman, Mr. Watts for the GAO said, "The IRS is taking the first step with this evolutionary process by developing a preliminary design concept, an acquisition strategy, a transition plan, and a management plan. These products are planned for completion in February 1988." Mr. Chairman, we will deliver those in February 1988.

So, from the standpoint of whether we are on track with our incremental approach, I submit that we are at this point.

With respect to the capacity issue that we have the 1992 and the 1994 gap, last year at this time we were simply discussing some general concepts.

This year we have proposed to GAO that we have some very specific ways of addressing the capacity gap. And one of the things that was mentioned in the testimony was our plan to offload work that we're presently doing on the weekends in order to be able to do it during the week and give us more capacity for the weekends, because that is where the concern is, on the weekends.

Now, Mr. Chairman, we have, we think, that information today, and we will be in the process of providing it to GAO so that they can actually take a look to see whether they agree with us. We have not done that yet. We haven't gotten together to do it.

Chairman PICKLE. Had you done that in previous years?

Mr. GIBBS. No. We have been in the process this year of developing this kind of information so we could present it to GAO. We have not done that yet, so they have not had the benefit of seeing it.

But we are to the point of being able to get that together and give it to them.

Chairman PICKLE. I think that is a good step.

Mr. GIBBS. Okay. So, my point is that we are making progress here, we think, and you'll have some more definitive ways along the way to measure whether—the progress we're making on TSR and whether we are going to be able to close the gap as we had planned.

Chairman PICKLE. Before you leave, Commissioner, I have another question to ask you, but let me ask Mr. Watts and Ms. Stathis when will you make to this committee your final report to us on taxpayer services? Will we have an additional report from you about this question between now and April the 15th?

Ms. STATHIS. We had not planned on making an additional report to you before April 15th, but if you would like to have one, we can certainly do that.

Chairman PICKLE. Yes, we would like to have that within that time frame. We will be in touch with you about that.

Now, Commissioner, the question had been raised a little bit earlier about the accuracy rate within some of the district offices.

And whether we take your figures at 25 percent of them being inaccurate answers or we take the GAO figures that 60 percent are inaccurate, I am asking you, can you or have you made any kind of analysis of the accuracy rate by the IRS districts? Is that a uniform figure? Is it heavier in some parts of the country than in others? And, if so, why?

Mr. GIBBS. Mr. Chairman, you will see in the statistics that accompany our testimony that we are able to break it down by regions, which is what you are talking about.

Chairman PICKLE. Yes.

Mr. GIBBS. And I would like to address it this way, I would like to say this—I would like to say two things to preface my remarks.

One, as I have said before, we are not pleased with three out of four. We think we can do better and ought to do better.

Second, I would like to comment that one of the things that I am about to say is simply not the fault of the GAO. The GAO has only had 6 days to do its calls and by Ms. Stathis' own testimony that is really not sufficient time.

So, I do not intend this to be a criticism. It is a statement of fact. I want you to focus on several things. We have placed 5,000 calls to 29 sites already this year.

In the 6 days that the GAO has had, they have only been able to place 224 calls to 29 call sites. That is an average, a raw average, of seven calls to each call site.

For that reason they have not been able to weight their figures as we have been able to weight ours to show the accuracy over a range of questions.

They will do this, they did this last year, but they haven't done it yet. That is the reason why in the testimony you were told that these results are, one, very preliminary; and, two, not projectable.

Now, let me explain what I think "not projectable" means at this time. If I called the IRS and they give me a wrong answer, one wrong answer to a question, I can say the IRS gave me a wrong answer to my question.

But I cannot project that experience to say that IRS is answering all the questions incorrectly.

Not until you get a sufficient base are you able to project the results that you are getting to what the performance is across the agency.

I think that is what Ms. Stathis is telling you in her testimony, that they simply have not had time yet to project the preliminary results across the program of the Internal Revenue Service.

On the other hand, with our 5,000 calls, we are able to do that. We may have some disagreements in terms of methodology, but in the final analysis ours, at this point, are projectable and GAO's are not.

Chairman PICKLE. GAO, did you only make 250 calls on the accuracy question?

Ms. STATHIS. That is right. As it says in the statement, I think we have made about——

Chairman PICKLE. Where did you make the calls? In one region or——

Ms. STATHIS. No, we have made calls to each of the call sites. We have made 13 percent of the calls that we planned to make this season, so we are at the very beginning of our survey.

Chairman PICKLE. All right, when we have a large number of calls, we would be interested in getting your figures. I want to compare. That is a limited number.

Mr. Commissioner, how long have your 5,000 calls been under way?

Mr. GIBBS. Since early January, not 6 days. And, again, please understand this is—I understand from GAO's standpoint, Mr. Chairman, they have only had 6 days. I don't think it's fair to ask them to do any more than——

Chairman PICKLE. I understand. If you have 5,000 calls, that means you have got a lot of IRS employees making calls to themselves?

Mr. GIBBS. No, what we have is a handful of IRS employees. What you try to do, Mr. Chairman, in order to get results——

Chairman PICKLE. Well, who is making the calls then?

Mr. GIBBS. Staff here in the national office in Washington, DC. We have a small staff of people who make the calls on a daily basis.

Chairman PICKLE. Well, I notice that you did not answer my question when I asked you whether there is some variance by regions.

I notice in the Southeast region, about 78.9 percent of them were giving accurate answers. And, yet, in the North Atlantic, it was 69 percent. That is a 10 percent difference. Why?

Mr. GIBBS. That is one of the things that our new system gives us the ability to do, Mr. Chairman. We can take a look at the different call sites and begin to get into them specifically by region to determine the reasons for the variances.

I mentioned that we had already brought people in from each of those regions into the national office.

And we sat down and actually went through what the differences were and why we had the differences and then came up with a plan as to how we were going to address them in each of the particular regions.

Chairman PICKLE. Well, I know you are going to try to address it. You have admitted that you could do a better job. Can you tell me again, by way of summary, what specific steps the IRS plans to take between now and April the 15th to improve the telephone accuracy as well as walk-in inquiries?

Mr. GIBBS. Yes, I can. We have already started. The first thing we did was to put this program in place to get accurate information. That was number one.

The second thing that we have done is to get representatives from all of the regions to come into the national office to discuss the results.

The third thing that we have done is to ask those representatives then to go back to the regions and actually begin to do additional training for the taxpayer assisters on the telephone.

What we are going to be doing each week, Mr. Chairman, is monitoring our progress and we're going to be looking for trends.

We have the capacity to do additional training. We have the technique to give the specific feedback on an overnight and weekly basis. And I think we have the desire within the people to basically stick with it to get a better result.

Chairman PICKLE. Well, what goal do you have? What overall accuracy rate do you expect your offices to obtain?

Mr. GIBBS. Mr. Chairman, when we went to the private sector, the private sector warned us not to set specific goals. What we're looking for is the very best we can do this year; 100 percent may not be attainable, but we're going to try to get as close as we can get.

Chairman PICKLE. Well, as I remember it, you had testified to us, I think, last year that you intended to have 90 percent accuracy in these replies on the call-in. Am I incorrect in recalling that?

Mr. GIBBS. I don't believe I mentioned a specific figure. I'll go back and check.

Chairman PICKLE. Eighty percent?

Mr. GIBBS. I don't believe I mentioned a specific figure, but I'll go back and check. Again, what we are trying to do is simply to increase——

Chairman PICKLE. Well, whether it was 80 or 90, you hope to get in that area if you can?

Mr. GIBBS. We certainly do this year, Mr. Chairman. Even with all the changes, we certainly hope this year to do no worse than last year.

By the same token, we're hoping to do substantially better. We will have to wait and see how we perform. But we have got the mechanism in place to test how we're doing. That's something we haven't had in the past.

Chairman PICKLE. And I want you to put in place some of these inventory systems for your forms.

Mr. GIBBS. Absolutely, on the walk-ins, I thank the GAO for their constructive criticism. We will take it to heart.

We've already begun taking a look at our inventory controls and management.

Chairman PICKLE. Now, Commissioner, one other question. Traditionally we have had to use seasonal workers, because the filing system is heavy from January until April and then we have always kind of slacked off.

Now, if you are going to have a telephone system and it is going to have the highest percentage of accuracy, we have got to have more permanency, I would think, in those people.

They have got to have more training and they probably ought to be on the payroll longer. Now, if that means we have got to have additional personnel for this purpose, at whatever level it takes to have it, then I think you ought to make that recommendation to us, this committee, and the Congress.

Because it is inexcusable not to have sufficient personnel and qualified, well-trained personnel. And I would think that if we have to rely always on seasonal employees—that is not nearly as desirable as having permanent personnel that are qualified and respected in the community.

So, my question to you, then, is do you anticipate that we can have more permanence in the personnel in these answering systems?

Mr. GIBBS. Mr. Chairman, let me answer that question this way. I think there is always a tendency, when you are having difficulties, to suggest that you can solve the problems by, if you will, throwing money at it, higher graded people, more experienced, that type of thing.

Chairman PICKLE. Oh, now, I am not making that kind of a statement.

Mr. GIBBS. Let me finish my statement, because I think you are going to like basically where I end up. I know you don't want to do that. That is my point.

We are not going to come back and just dump it on the basis that, well, we need higher paid personnel. We are not going to do that to you.

But I think your point is a good one. We are going to be taking a hard look this year at the mix between our temporary employees and our permanent employees. We do have the more experienced people that our seasonal people can refer questions to. We're going to be taking a hard look at that with this program.

If I see the need, and I suspect I may, to come back and ask for more experienced personnel, better grades, more pay, there's going to be a cost factor with that. But I promise I won't do that without examining all of the alternatives. If I feel we need it, then I'll come back and ask for it.

Chairman PICKLE. That is fine. I am just simply saying to you and to the Internal Revenue Service and to this administration, if we need these qualified personnel, the Internal Revenue Service ought to ask for it. You ought to be honest with us if you need them.

And I think the Congress, then, has got the challenge to meet that request.

Mr. GIBBS. Mr. Chairman, I think you will be pleased with our 1989 budget. You have supported us. And believe me in the taxpayer service area, I have asked for additional resources and you'll be pleased to know that the administration is sending you a budget with additional resources for taxpayer service and the service centers of 1989.

Chairman PICKLE. Well, we are doing better. But I also remember the scout master that told the scout to escort this little old lady across the street and it took him an hour to do it. And he said, "Why did it take you so long?" And he said, "She didn't want to go. She didn't want to cross the street."

And we have been saying to the Internal Revenue Service, do you need some more help, more money. And they said, "No, we don't need it."

Mr. GIBBS. I haven't said that.

Chairman PICKLE. You haven't and I'm not asking you to go down there and get your courage to ask for a lot more money. But, if more money is necessary to maintain good permanent personnel then we ought to ask for it, because the taxpayer is entitled to get good service if he's going to pay his taxes for it. And that's all I'm asking.

Now, the previous years the administration hasn't done that. I think now they see that for every dollar we put into the Internal Revenue Service, by and large, we'll get a—maybe a 5 to 1 return for it.

So, it makes sense, fiscally, that we do that. And it makes sense from a service standpoint.

Mr. GIBBS. Mr. Chairman, could I just comment that in preparing for this year's testimony, I read something from a great man who said this last year, he said, "I always contend as a former PR man that one of the best things the Internal Revenue Service could do would be to beef up taxpayer service and really hire the best, smiling, genial, helpful people they can. And take the aggressive attitude away by saying, 'How can we help you,' and really meaning it." Do you remember those?

Chairman PICKLE. Who said that? [Laughter.]

Mr. GIBBS. You did and that is what we are doing this year.

Chairman PICKLE. Well, Commissioner, we'll conclude this hearing on that happy note. [Laughter.]

I do believe it and I do think that this present IRS office has put more emphasis on taxpayer services than in previous years, any previous period.

I think it's welcomed by the American people and I think it brings out a spirit of more congeniality and happiness within the employees.

My employees in Austin, TX, are a spirited group. Last year, in order to try to get early filing, they actually offered to wash cars

on Saturday morning. You would get a free car wash if you filed a little early.

I don't know how many more extra ones we got, but it was a good spirit. And I think that's prevailing over the country. That's good.

And we're not trying to just spend money, and you know that, because it is very difficult. But at the same time, we are now embarking on a new program and we've got a new tax system and we must make it work.

And, so, I appeal to you to keep up this taxpayer service and I am going to ask you people to give me another report here by April the 15th, on the taxpayer service. And at that time I want more than 250 calls by GAO to make a comparison against the IRS 5,000 calls.

Altogether, I have to say that I think we're off on a good course. I don't have the pessimistic view that a lot of the practitioners, or the public generally, or the media has about the IRS.

I do think we ought to be honest because we are making 2,000 more changes in the Tax Code, and the most sweeping changes in nearly 40 years. We've got to expect a lot more problems and we must address them with all the force that we can.

I thank you. I appreciate the testimony. And we will have another hearing on this before too long. Thank you very much. The subcommittee is adjourned.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

APPENDIX A

J.J. PICKLE, TEXAS, CHAIRMAN
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A.L. SINGLETON, MINORITY CHIEF OF STAFF
MICHAEL A. SIKORSKI, COUNSEL TO THE MINORITY

February 26, 1988

The Honorable Lawrence B. Gibbs, Jr.
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Gibbs:

I want to thank you for your assistance and testimony at the Oversight Subcommittee's February 23, 1988 hearing on the 1988 filing season. In order to complete the record on the 1988 filing season hearing, I would appreciate your response to the following questions by the close of business March 18, 1988.

1. In your testimony you expressed concern about taxpayers filing returns later and later each year, and the impact this will have on IRS peak workloads.

   a. If the number of returns filed in April increases by 5% or more, what problems will that cause in the returns processing pipeline?

   b. Will staff be shifted from other functions to handle the increase and, if so, from which functions?

2. Booz-Allen conducted focus group interviews last year to test the Forms 1040, 1040A, 1040EZ, Schedule A, IRA contribution forms, and home mortgage interest forms.

   a. What changes were made to relieve the problems identified by Booz-Allen?

   b. What problems are occurring which Booz-Allen failed to identify?

3. You have estimated that the error resolution workload for this year will increase by 3.2 million as a result of Tax Reform Act changes in the law.

   a. In light of the types and frequency of errors detected on returns filed thus far, have you revised the error resolution projections?

b. What impact will an increase in the error resolution workload have on the IRS' adjustments and unpostables workloads?

4. You noted that the telephone circuitry at all of the call sites has been increased to handle peak demand.

   a. Which call sites are experiencing the greatest increase in demand? What is the overflow rate for each of the call sites?

   b. Have any call-sites experienced an interruption in taxpayer assistance due to problems with the telephone system? If so, which sites and for how long was service interrupted?

   c. What contingency plan exists in the event that the telephone system cannot handle the demand?

5. This year 16 district offices and 2 service centers will offer electronic filing. When will electronic filing be available nationwide?

6. Your testimony indicated that over the past year progress has been made on the Tax System Redesign.

   a. Have the Department of the Treasury and the Office of Management and Budget given their approval to Tax System Redesign?

   b. How many people are assigned under the Assistant Commissioner for Tax System Redesign? Are you able to attract and keep people who have the high level of skill necessary for this project?

7. In the past the IRS has experienced difficulties in processing its payroll at the Detroit Data Center.

   a. Have these problems been resolved?

   b. Were W-2's for all IRS employees distributed prior to the January 31, 1988 deadline?

Lastly, as I indicated during our visit, I expect to hold another hearing on the 1988 Filing Season at the end of March. Therefore, it would be helpful if you could supply weekly updates on the following items:

1. Data from the Integrated Test Call Survey: This should include the accuracy rate nationwide and regionally; the types of questions which are causing assistors the greatest difficulty; and, the questions most frequently asked by taxpayers as submitted to the National Office by the call-sites?

2. Data on the Filing Season: This should include the number returns filed and processed; the number of refund returns; the average refund amount; and, a comparison to data from the same time last year.

3. Data on the Availability of Forms: This should include the turn around time for orders placed on the toll-free form line; a list of forms unavailable and the reason they are not available; and, the backlogs in filling orders at distribution sites.

4. Data on Service Center Inventories: This should include current inventory levels for adjustments, unpostables and error resolution at each Service Center and a comparison with the levels at the same time last year.

5. National Office and Field Communications: This should include a copy of the minutes from both the Conference Call to Regional Tax Reform Coordinators and Public Affairs Officers and the Weekly Significant Events Call for Assistant Commissioners for Computer Services and Taxpayer Service and Returns Processing.

6. Data on Computer Operations: This should include the critical problems which were reported to the National Office Command Center and the length of time before resolution of the problem.

You may be assured I share your hope for a smooth filing season and look forward to working with you.

Sincerely,

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/sal

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

MAR 1 3 1988

The Honorable J.J. Pickle
Chairman
Subcommittee on Oversight
House Ways and Means Committee
Washington, D.C. 20515-6348

Dear Mr. Chairman:

I want to take this opportunity to thank you for inviting me to testify at your Subcommittee's February 23rd hearing on the 1988 filing season. I value your interest in and concerns about the IRS and believe that the forum you provide to examine our operations is a valuable help to our agency.

We have received your letter containing follow-up questions to the hearing and are working on the responses to those questions. However, I thought you would be interested in the status of some of the issues that we discussed at the hearing.

Regarding the accuracy rate for our toll-free telephone assistance, the latest figures show that our accuracy rate for the week ending March 5th had increased to 77.3%. (As of the date of the hearing, the rate was 74.8%.) Our cumulative accuracy rate for the year now stands at 76.1%. I want to reiterate my position that I am not satisfied with our answering only three out of four questions correctly, but it looks like we are improving. With our new Integrated Test Call System, we are able to quickly target areas that need work in each local office. We have already begun to provide assisters with supplemental training as necessary. I think that the increase we are seeing is reflective of those efforts.

We are also in contact with GAO and are jointly reviewing their test call system as well as ours. In particular, we are in the process of reviewing the questions each of us is using to insure that we are getting accurate results from our test calls. Furthermore, GAO visited IRS during the week of March 7 to monitor calls, discuss response evaluation and sample design and to take a look at the software being used by callers to document contacts. In the weeks to follow, IRS will visit GAO to conduct a similar review of their test call system. We believe that these efforts will go a long way towards insuring that we won't wind up with widely divergent results in our respective monitoring of phone calls.

The other immediate area of concern that arose at the hearing was the issue of maintaining adequate supplies of forms. We have already contacted our local offices to insure that this problem is corrected. In addition, during the week of March 7, our Publishing Services people, who have primary responsibility for forms distribution, met with personnel from around the country to formulate better inventory controls, standard stocking patterns and redistribution strategies. These procedures insure that local offices do not run into the types of problems that were noted by GAO in their review prior to the hearing. Over the long run, we intend to develop standardized procedures and training of local office employees regarding inventory management and reorder activities.

We have also made a concerted effort to provide supplies of forms to post offices, banks and libraries which should insure available supplies for meeting last minute demands for forms by taxpayers. Because participation in our tax form distribution program is strictly voluntary, we attempt to support them in every way possible as they assist in our forms distribution mission. Libraries and post offices may reorder forms on a special toll-free number. Reorders to our Florence facility, which supports this program, are usually processed within a 24-48 hour timeframe and allows participants to receive their reorder shipment within five to six working days. In order to make this program as successful as possible, we scheduled a planning session for March 11-14 in Florence Kentucky to evaluate current program operations and to formulate plans for the remainder of the filing season.

Another issue that you and I share a mutual concern about is the question of mainframe computer capacity in the 1990's. We are continuing our discussions with GAO on this issue and are hopeful that the data which we have will allow GAO to verify the soundness of our plans to extend capacity until at least 1994. We expect to have a report ready for GAO to review the week of March 21 and intend to discuss that report with Joe Grant of your staff the following week.

Finally, I wanted to let you know of the work we are doing on the subject of waiving penalties due to incorrect advice given the taxpayer by an IRS employee. We have reviewed our policy of abating penalties in such situations and intend to publicize that policy in the near future. The following are the principal aspects of that policy:

1. Erroneous information provided by the IRS is reasonable cause for considering the abatement of most penalties which the majority of taxpayers would encounter. This would include penalties for late filing, failure to pay, and negligence.

2. The policy of abating penalties would not apply to all penalties. In some cases there is no legal basis or it would be bad policy to abate the penalty. Examples would be the substantial understatement penalty and the bad check penalty.

3. Return preparers and sophisticated business taxpayers would not automatically be excluded from a penalty waiver but because of their sophistication with the tax law, there would be a higher standard for abatement.

4. When asking IRS to abate a penalty due to erroneous IRS advice, the taxpayer would be required to make that request in writing. The taxpayer should be prepared to give certain details concerning his efforts to get the answer, as well the name, date and time he spoke with the IRS employee.

I would be happy to have a member of my staff brief you or your staff on the details of this policy if you so desire.

I hope that this information demonstrates that we appreciate your concerns about this filing season. If you have any questions about the information in this letter, please do not hesitate to call me personally. Your staff may contact Gayle Morin, Director of our Legislative Affairs Division, on 566-6070.

With kind regards,

Sincerely,

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

APR' 1 1988

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
House Ways and Means Committee
Washington, D.C. 20515-6350

Dear Mr. Chairman:

This is in response to your letter of February 26, 1988, asking a series of follow-up questions to the February 23rd hearing on the 1988 filing season. Enclosed are the answers to the questions you asked with the exception of the question related to the Booz-Allen Focus Groups. The answer to this question will be forthcoming in a matter of days.

If your staff has any questions about the enclosed material, please have them contact Gayle Morin, Director of our Legislative Affairs Division, on 566-6070.

With best wishes, I am

Sincerely,

Bryan Slone
Assistant to the Commissioner
(Legislative Liaison)

Enclosures

Question:

1. In your testimony you expressed concern about taxpayers filing returns later and later each year, and the impact this will have on IRS peak workloads?

   (a) If the number of returns filed in April increase by 5% or more, what problems will that cause in the returns processing pipeline?

   (b) Will staff be shifted from other functions to handle the increase and, if so, from which functions?

Response:

(a) If the number of returns filed in April increases by 5% or a somewhat higher range, the increased volume will not create problems in the returns processing pipeline. The trend has been for taxpayers to file returns later and later each year and we have planned accordingly. Our projection included later filing due to changes in the law and forms as a result of the Tax Reform Act.

(b) In planning for our staffing and training needs for the 1988 processing seasons, consideration was given to the possibility of a greater than 5% increase in the volume of returns filed in April. In the event that unmanageable workload conditions arise at a service center, we do have contingency plans that provide for options such as crossfunctional assignments in the service center, shipment of returns and other documents between service centers to even out workloads, or use of a back-up processing facility, depending on the nature of the workload condition.

Question:

3. You have estimated that the error resolution workload for this year will increase by 3.2 million as a result of Tax Reform Act changes in the law.

(a) In light of the types and frequency of errors detected on returns filed thus far, have you revised the error resolution projections?

(b) What impact will an increase in the error resolution workload have on the IRS' adjustments and unpostables workload?

Response:

(a) In monitoring the types and frequency of errors detected on returns filed thus far, the actual occurrance of errors has been less than the projections. Since the error rate has been well within our estimated range, we have not revised our original error resolution projections.

(b) An increase in the error resolution workload would result in an increase in the adjustments and unpostables workloads. Accordingly, the 3.2 million net additional errors that Tax Reform was expected to generated was a factor in our overall projections for this year's adjustments and unpostables workload. However, since the actual number of errors is under our projections, we have not subsequently changed our estimates on adjustments and unpostables workloads.

Q4A. Q: Which call sites are experiencing the greatest increase in demand? What is the overflow rate for each of the call sites?

A4A. A: The following cumulative information represents data through the week ending February 27, 1988.

Site	Demand vs Scheduled	Overflows
Nashville	+35.2%	.3M
Jacksonville	+21.8%	.4M
Richmond	+18.8%	.1M

Site	Demand vs Prior Year	Overflows
Pittsburgh	+53.6%	.1M
Jacksonville	+33.8%	.4M
Honolulu	+28.8%	.02M
Richmond	+25.3%	.1M
Indianapolis	+17.2%	.2M

Q4.B. Have any call sites experienced an interruption in taxpayer assistance due to problems with the telephone system? If so, which sites and for how long was service interrupted?

A4B.

Sites	Downtime Minutes as of 3/9/88
Anchorage	201
Baltimore	23
Brooklyn	60
Buffalo	84
Cleveland	215
Dallas	10
Denver	50
Detroit	10
Honolulu	20
Nashville	60
Newark	210
Philadelphia	22
St. Louis	292
St. Paul	6
Seattle	435

Q.4.c. What contingency plan exists in the event that the telephone system cannot handle the demand?

A.4.c. Each of the seven regions would be able to handle an increase in telephone demand of approximately 20 percent by increasing circuitry above current levels and/or by implementing one or more of several options to increase staff-hour availability on the telephones. Among the ways to increase staff-hours are to extend the tours of duty of part-time employees and to close referral gates temporarily to utilize the referral staff on the front lines. Other steps to help meet an increase in demand beyond our projections follow:

- extend the hours of operation at toll-free telephone sites in an effort to spread out additional volumes of telephone calls over more than just the standard eight-hour day;
- direct specific categories of technical tax questions to special banks of telephones staffed with details-in to Taxpayer Service;
- shift account referral work from districts to the service centers in an effort to maximize the use of staffs answering technical tax questions;
- launch aggressive special publicity efforts to direct taxpayers to our Tele-Tax and Taxpayer Education programs to help reduce the demand for telephone assistance at our toll-free sites.

5. This year 16 district offices and 2 service centers will offer electronic filing. When will electronic filing be available nationwide?

Response:

Current scheduling provides that electronic filing will be available nationwide for Tax Year 1990 returns, which are processed in 1991.

6. Your testimony indicated that over the past year progress has been made on the Tax System Redesign.

a. Have the Department of the Treasury and the Office of Management and Budget given their approval to Tax System Redesign?

The draft Management Plan has been reviewed by both Treasury and the Office of Management and Budget and they are in concurrence with the way we plan to proceed and are pleased with our recent progress.

b. How many people are assigned under the Assistant Commissioner for Tax System Redesign? Are you able to attract and keep people who have the high level of skill necessary for this project?

There are presently 202 people on board as of February 29, 1988. We have been having difficulty attracting personnel with the necessary technical skills; however, we are currently undertaking a recruitment effort. We are facing the same problems as the rest of the Federal Government - salaries are not competitive in the technical skills areas necessary for this project. In the meantime we are using contractor assistance through an agreement with the Office of Technical Assistance at GSA.

Payroll Problems

In the past the IRS has experienced difficulties in processing its payroll at the Detroit Data Center.

Question: Have these problems been resolved?

Answer: The adjustments backlog has been reduced by 70% enabling the Service to meet its goal of processing pay adjustments within two pay periods of notification of an error and receipt of the necessary supporting documents. The Service has also initiated three additional efforts geared to alleviating this type of problem:

- we have authorized the hiring of 80 additional payroll clerks in the Detroit Data Center. Most of these positions have been filled, and the employees are trained and now working "live" accounts. As these new employees become better experienced, productivity will increase even more.

- we are revising our training of field payroll personnel by consolidating the personnel/payroll processing and personnel data input courses to incorporate all areas of the personnel/payroll processing environment into a systematic, computer-intensive approach to data processing. and

- we are installing new "user-friendly" computer input screens developed by the Bureau of Engraving and Printing. These screens will make processing much easier for inexperienced personnel, thus accelerating their proficiency and productivity.

Question: Were W-2's for all IRS employees distributed prior to the January 31, 1988, deadline?

Answer:
- We mailed out 165,400 1987 Forms W-2 prior to January 31, 1988.
- The remaining 441 Form W-2s were either rejected by the system or represented difficult employee accounts; therefore, required research and manual preparation. All have been mailed to date.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

MAY 12 1988

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
House Ways and Means Committee
Washington, D.C. 20515-6350

Dear Mr. Chairman:

This follows-up on our letter to you dated April 1, 1988, in which we provided answers to questions you had as a result of the February 23rd hearing on the 1988 filing season. One question you asked pertained to the changes made to relieve the problems identified by the Booz-Allen focus groups in our draft forms for 1987. Enclosed is a summary of the changes that were made as a result of that testing.

This completes our response to your questions pertaining to that hearing. If your staff has any questions about this material, please have them contact Michael Black of my staff on 566-4036.

Sincerely,

Gayle Morin

Gayle G. Morin
Director
Legislative Affairs Division

Enclosure

2. Booz Allen conducted focus group interviews last year to test Forms 1040, 1040A, 1040EZ, Schedule A, IRA contribution forms, and home mortgage interest forms.

a. What changes were made to relieve the problems identified by Booz Allen?

b. What problems are occurring that Booz Allen failed to identify.

Response:

Revisions made to Form 1040EZ:

The sentence "Please read the instructions for this form on the reverse side." was added to the front of the form. It was discovered that some taxpayers were not aware that instructions were on the back of the form. Many taxpayers do not read instructions before starting to complete tax forms. Therefore, whenever we can encourage taxpayers to do so will, we hope, make completion of the forms easier and reduce the error rate.

Significant changes were made to line 4, the standard deduction line. A change in the law provided for different standard deduction amounts and limited the standard deduction amount for persons that can be claimed as dependents of others (affecting students primarily). Therefore, Form 1040EZ for the first time had to provide for a standard deduction calculation. The testing identified problems participants were having in determining whether this new provision applied to them, and in making the proper calculation, as called for by the first version of the form tested. The testing led to the addition of yes and no boxes to be checked in answer to the question "Can you be claimed as a dependent on another person's return?" A worksheet was placed on the back of the form to help in determining the amount of their standard deduction.

Changes were also made to line 6. Because of a change in the law that eliminated the personal exemption for any person who can be claimed as a dependent of another, we could no longer preprint the personal exemption amount on the form. The focus group testing identified problems taxpayers were having in determining whether they could or could not claim the personal exemption. The final version of the 1987 Form 1040EZ contained wording and graphics to make this provision of the law as clear as possible.

Graphics and word changes also were made to the instructions on the back of the form as a result of the testing, including the use of bold subject matter headings in the left margin. This provided space to allow more instructional matter to be provided without requiring another page of instructions.

Revisions made to Form 1040A:

As a result of the focus group testing, some minor changes were made to the front of the Form 1040A. In Step 3, the "Caution" relating to filers who can be claimed as a dependent of someone else was moved from below to above lines 5a and 5b, to increase the likelihood that the "Caution:" will be read. Also, the heading for line 5c, column 5 was changed to "No. of months lived in your home in 1987," for clarification purposes. Also, the words "Taxable" and "Tax-exempt" in lines 7a and 7b were put in boldface print.

The major changes to the form, however, were in lines 14 and 16. A change in the law greatly increased the complexity, and therefore the steps involved, in determining the standard deductions for certain groups of taxpayers, including persons,

primarily students, who can be claimed as a dependent by another taxpayer, and persons blind or 65 or over. As a result of problems encountered in testing the first version, three subsequent revisions were made. Focus groups testing the final version had significantly less difficulty with the form than earlier groups. A box was added on the right side of line 14a, to indicate more clearly that the total number of boxes checked should be entered here. On line 14b, the parenthetical phrase, "(such as your parents' return)," was added to reduce confusion regarding the intent of this line. Changes were made to address the failure of taxpayers subject to the exceptions on lines 14a, b, or c to consult the instructions to determine the appropriate standard deduction amount. The line 14d instructions on the form were changed from:

> "Enter the amount shown below for your filing status. Caution: If you completed line 14a, b, or c, see page 22 of the instructions for the amount to enter on line 14d."

To:

> "Standard deduction. If you checked a box on line 14a, b, or c, see page 22 for amount to enter on line 14d. If no box is checked, enter amount shown below for your filing status."

The sentence concerning filers who used lines 14a, b, or c was placed first to increase the likelihood that these individuals will refer to the instructions to determine their line 14d entry.

Additional changes were made to the line by line instructions for the forms, most significantly those relating to line 14.

Revisions made to Form 1040:

The changes made to Form 1040 were very similar to the changes made to Form 1040A. As on the Form 1040A, the "Caution" relating to filers who can be claimed as a dependent of someone else was moved from below to above lines 5a and 5b. Also, the heading for line 5c, column 5 was changed as on the Form 1040A.

The major changes to the form were made to lines 32 through 35. These lines are analogous to lines 14 through 16 of Form 1040A, except they must also make provision for those taxpayers who itemize. The earliest version tested had a caution in the left margin that applied to taxpayers who checked one of the boxes on line 32a, b, or c, but did not itemize. The problem identified was getting people to read the caution and, if it applied, turn to the instructions. The final version placed a boldface arrow opposite line 33b pointing to the caution. Although testing indicated that these lines, because of new complexity in the tax law, would cause some confusion among taxpayers, the later version developed did seem to be a considerable improvement. Concomitant changes to the line by line instructions were made.

Revisions made to Schedule A, Form 1040

The major changes to the tax law affecting the Schedule A were the elimination of sales tax deductions and the revised treatment of home mortgage interest and miscellaneous deductions.

Problems encountered in testing centered more on the instructions rather than the form itself. Some confusion regarding certain concepts was evidenced, such as personal property tax, deductible home mortgage interest, and deductible points. There was some confusion regarding the appropriate line on which to enter various categories of miscellaneous deductions.

The instructions were substantially revised to address many of the concerns raised by the focus group participants. Section headings were revised to emphasize the instructions corresponding to each line item. Additional text was added to clarify the distinction between deductible and nondeductible interest and points. The discussion of miscellaneous deductions was rewritten to emphasize the types of expenses that are allowable deductions on each line in this section, as well as the fact that most of these deductions are subject to the two percent Adjusted Gross Income floor.

Revisions to Form 8606 and IRA worksheets

Problems during focus group testing were encountered with both the IRA worksheets from the Form 1040A instructions and the Form 8606, Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions. Problems with the IRA instructions and worksheets centered on selection of the correct worksheet and understanding of "covered by an employer's retirement plan," as well as some problems with specific worksheet line items. The most significant problem associated with the Form 8606 was an inability to comprehend the purpose of the form and the meaning of the "bottom line" that is calculated. Participants also had difficulty with the terminology used in some of the form's line items.

The 1987 Form 8606 was revised once during testing. Both the Form 8606 and the IRA worksheets and instructions were substantially revised based on focus group participants' comments following the completion of testing. The IRA instructions were revised to clarify the worksheets that appropriately should be completed by various categories of taxpayers, and to emphasize the need for some filers to complete a Form 8606. The instructions for the Form 8606 were significantly revised to include, among other changes, a greatly expanded explanation of the purpose of the form and the meaning and use of the "bottom line" calculation.

Revisions to Form 8598, Home Mortgage Interest

Some of the problems encountered during testing included unfamiliar terms, failure to find necessary information in the separate instructions, confusion over computation of the average loan balance, and difficulty with the columnar format in Part III.

Based on the focus group testing and further analysis, the Service revised the Form 8598 extensively. Among the changes:

The Service highlighted the fact that Part II is simpler, but Part III is more exact, and therefore possibly more beneficial for the taxpayer. Also, the Service revised the separate instructions, allowing taxpayers who only used mortgage proceeds for certain specified purposes to stop after Part I, as long as the total amount of all mortgages did not exceed the fair market value of the filer's home at the time each mortgage was taken out.

Reducing the methods for determining average balance from five to three. The remaining methods were reordered so that the methods most likely to be used appear first.

Rewriting the instructions at the top of the form to limit the use of terms that focus group participants found confusing or unfamiliar. The last paragraph of the instructions utilizes bold bullet points to direct the reader to the separate instructions to learn about average balance, purchase price plus improvements, and the significance of a pre-August 17, 1986, mortgage amount.

Line 1 was rewritten to emphasize "each mortgage" and the importance of using one of the average balance methods.

To line 3 was added the phrase "other than to buy your home" and "otherwise, enter zero" to address a common focus group error.

To line 5 was added the sentence "If you have deductible points, see the separate instructions."

A number of other graphic and word changes were made, and parallel changes were made to the separate instructions.

What problems are occurring that Booz Allen failed to identify?

1. Forms 1040 and 1040A contain entry spaces to the right of the exemption area for taxpayers to indicate the number of exemptions they are claiming for several categories of exemptions. (For example, Form 1040 contains a box to enter the number of parents listed as exemptions.) Although taxpayers are entering the proper total number of exemptions, some are entering numbers in the wrong boxes.

2. Some taxpayers are having difficulty multiplying percentages. An example is on Schedule A where taxpayers need to multiply their personal interest by .65 to find the deductible amount.

3. Form 1040EZ contains a "Yes" and "No" box for taxpayers to indicate if they can be claimed as a dependent on another person's return. Some taxpayers are not checking either box.

4. Schedule A, Form 1040 contains two sections for entering Miscellaneous Itemized Deductions--one for deductions subject to the 2% floor, and one for deductions not subject to the floor. Some taxpayers are entering their deductions in the wrong section. Also, some taxpayers are applying the 2% floor using some amount other than Adjusted Gross Income.

5. Employee business expenses are claimed either on Schedule A or as an adjustment to income on Page 1 of Form 1040, depending on whether or not the expenses were reimbursed. Some taxpayers are confused about employee business expense being claimed on these two separate lines of the return, which can result in deductions being computed on the wrong area of the return.

APPENDIX B

1988 Filing Period Readiness Group Final Report

November 25, 1987

Department of the Treasury
Internal Revenue Service

Background

Planning for the 1988 filing season started even as the Tax Reform Act was in the formative stages. Many meetings were held with members of the operational functions to determine how particular proposals would affect various Service functions and how they could be administered. As the bill developed, some Requests for Data Services (RDS) were prepared and acted upon prior to the enactment of the legislation. As the bill was reaching its final stages, the functions developed lists of items requiring early action.

After the bill was enacted on October 22, 1986, the early action items received priority attention, and drafts of forms and procedures were developed. Even as the early action items were being resolved the larger task of developing a detailed implementation plan was initiated. The final plan contained more than 400 pages and approximately 2000 separate action items.

The 1988 Filing Period Readiness Group was created as a subgroup of the Executive Steering Committee to ensure that the Service's preparation for the 1988 filing season is complete and provides for a smooth implementation of the Tax Reform Act as it affects 1) Taxpayer Service, 2) Forms Development and Distribution and 3) Service Center Processing of 1987 Tax Returns.

Pat Ruttle, Regional Commissioner Central Region, was appointed as the initial Chairman of the Readiness Group. After Pat was selected to chair the Executive Steering Committee, Ray Keenan, Director Memphis Service Center, was selected to chair the Readiness Group. Other group members representing field and National Office Officials include:

- John Ader
  Deputy Assistant Commissioner,
  (Taxpayer Service and Returns Processing)

- Wally Hutton
  Deputy Assistant Commissioner (Computer Services)

- Orion Birdsall
  Deputy Assistant Commissioner (Human Resources Management and Support)

- Francine Crowley
  Assistant Regional Commissioner (Data Processing),
  North Atlantic Region

- Ira Loeb
  Director, Springfield District

- Prescott Berry
  Director, Phoenix District

- Charles Combs
  Internal Audit Manager, Central Region

- Rudy L. Glismann
  Program Analyst, Planning Staff,
  (Assistant Commissioner Taxpayer Service and Returns Processing)

The group met and developed critical issues and areas of concern to review. The issues were developed utilizing input from Regional Commissioners, the Returns Processing Conference held in June, the Taxpayer Service Conference held in July and concerns of group members.

During the week of August 17 the group collected information regarding these issues through interviews of National Office managers. Major functions represented included: Taxpayer Service, Returns Processing, Computer Services, Publishing Services, Forms & Publications, Distribution Centers, Public Affairs, Internal Audit and Integrated Management System.

Follow-up interviews were conducted in the same functional areas during the week of October 5. On the basis of these interviews, and other work of the group, recommendations were developed for follow-up by the appropriate responsible Assistant Commissioner.

During the review process a host of issues were considered. Particular emphasis was placed on the group's assessment of the adequacy of the planning being performed by each functional area. Many issues that were critical during the time frame during which the reviews took place (July thru October) have been resolved.

This report is not intended to provide a history of the study group's activities. Rather it is intended to provide an assessment of the Service's readiness for the 1988 Filing Season in three major functional areas (Taxpayer Service, Forms and Publications and Service Center Processing), and to identify specific items that require continued management attention as we move into and through the filing season.

Assessment

The three functional areas were intensively involved in planning for implementation of the Tax Reform Act and preparations for the 1988 Filing Season. They were all aware of their responsibilities and detailed plans were already in place when our review began. All functional areas had established goals and identified potential problem areas that they were addressing. We found the planning efforts to be thorough and of high caliber.

However, there was one significant unknown that continued to haunt us during the review process. It was -- will there be legislation passed late in the year (November, December) that would impact negatively on the Service's preparation for the filing season, including Budget Reconciliation, Technical Corrections, and Taxpayer Bill of Rights. Futhermore, if Budget Reconciliation is not enacted the automatic provisions of Gramm-Rudman would be implemented. These could all have a significant negative impact on filing season readiness depending on the specific provisions enacted and their effective dates.

Some Planning Highlights for Each Functional Area

Returns Processing and Accounting

1. Made extensive efforts to develop detailed workload projections for each Service Center, including; changes in filing by type of return, from refund to full-paid return, movement of filing pattern closer to April 15, volume of returns going through the Error Resolution System, peak remittance processing workload and unallowable items workload.

2. Provided recommendations to the Commissioner to determine the Estimated Tax Penalty policy for Tax Year 1987.

3. Recognized the need, established target dates, and provided procedural handbooks and training materials timely to the Centers.

4. Visited all Service Centers and reviewed with managers the impact of Tax Reform on Center Processing.

5. Coordinated with Computer Services the early submission of Requests for Data Services.

6. Emphasized the need for reductions of Service Center inventories.

Taxpayer Service

1. Completed readiness checks in all Regions and follow-up items communicated to each Region.

2. Developed training materials early and established plans to complete training well before the filing season begins.

3. Completed plans for early hiring and training. Funding provided for adequate on the job training and retention of new hires.

4. Issued Manual Supplement dealing with Quality Performance.

5. Excellent detailed planning for Taxpayer Information and Education included the production of PBS New Legislation Tax Clinic as an example.

6. A back-up telephone system (DACON) which uses a call sequencer will be in place in all toll-free VEGA sites which use an automatic call distributor.

7. In conjunction with the SOI Division and GAO, developing an improved system to measure the quality of responses to Technical Tax Law inquiries. Will help identify soft spots and allow for corrective steps.

8. Funding provided to all regions for extended hours of taxpayer assistance.

9. Tele-conference was held with the Commissioner and National, Regional, and District Taxpayer Service Managers.

10. Three telephone answering back-up sites have been established for use by any site experiencing significant down time.

Computer Services

1. All Requests for Data Services needed for the 1988 filing season are complete and available for testing.

2. Systems Acceptability Testing is on or ahead of schedule with no major problems identified to date.

3. Visits have been made to all Centers to provide a briefing on the changes for 1988.

4. Hardware Readiness Reviews have been completed at all Centers.

5. There are three back-up UNISYS 9040s (Front End Processor) available, and a fourth is being refurbished and is expected to be available for the filing season.

6. The Communication Replacement System Pilot in Fresno is being closely controlled and monitored. Emphasis on delivering a quality system continuing.

7. The Command Center continues to work well and will continue to be operational in 1988.

Tax Forms and Publications & Publishing Services

1. Excellent coordination between Forms Development and Publishing Services allowed draft Form 1040 series and related schedules to be completed earlier than ever before. This allowed time for public and practitioner reaction before forms were finalized.

2. Although numerous problems were encountered, contracting for the printing of forms was completed timely.

3. Publication 1045 (Information For Tax Practitioners) was sent to practitioners early.

4. Close working relationships between Publishing Services and CID's sites was developed.

5. The schedule for completion and printing of Tax Publications is tightly controlled. The Deputy A/C (Human Resources Management and Support) conducts weekly status meetings.

6. A contingency plan for fall-back printing is in place with GPO.

7. Publications 920 and 921 which explain the provisions of Tax Reform for individuals and business were made available for the public timely.

Public Affairs

1. The Fall Outreach Campaign has been initiated.

2. The Practitioners Tele-conference was held in October.

3. The mailout to over 90 million Taxpayers, highlighting key provisions of Tax Reform and making known the availability of Publication 920 (Explanation of the Tax Reform Act of 1986 for Individuals) was completed.

4. Plans have been made for a bi-weekly press conference during the filing season.

5. Working with the National Advertising Council in developing a campaign emphasizing timely and accurate filing of tax returns.

Follow-up Items -- 1988 Filing Period

As a result of the Study Group's Review, the following items were identified as requiring continued attention and follow-up. The responsible officials are identified in the index at the end of this report.

Service Center

1. Monitor Service Center work load receipts compared to projections because the Tax Reform Act provides extensive changes to our system. Should the public react by filing returns measureably later than normal, Service Centers could have serious problems at the April 15 peak. While we concluded the methods used for workload projections were very good, a sense of unpredictability exists. Close monitoring of receipts will allow time for revising contingency plans if conditions warrant.

2. Ensure that all Service Centers are knowledgeable in how to manage the Error Resolution System to prevent over-flow conditions. This will be accomplished by providing specific training to key personnel from each Service Center after consultation with each Region/Service Center to determine Center by Center needs.

3. Continue emphasis on Service Center inventory reductions in preparation for the filing season.

4. Monitor recruitment at all Service Centers but give particular attention to Andover. Provide assistance as necessary and consider transshipping returns if necessary. Deputy Assistant Commissioner, Human Resources will continue biweekly briefings.

5. Ensure that Returns Processing staff the Command Center with analysts who have broad service center processing knowledge.

6. Have conference calls with ARC's (Data Processing) and Service Center Directors weekly during the filing season. The study group strongly recommends that, at a minimum, this technique be used during the late January through February time period. We need excellent communications this year.

7. Update, emphasize, and issue the Workload Assistance Plan. This can be a good safety net should an individual center encounter processing problems.

8. Continue close monitoring of 9040 Computer Performance in each center.

9. Continue to review and update plans for the Communications Replacement system testing and installation. The pros and cons should be weighed very carefully before a decision is made for implementation at any center during the filing season.

10. Ensure that Computer Services "hub tests" 1988 programs at the Memphis Service Center with adequate staffing to promptly correct problems that are identified. On site-support will also be provided at the other Centers.

11. Ensure that Computer Services conducts a meeting with key personnel from each Service Center in December to review "end of year" procedures in detail.

12. Ensure that additional DIS nodes are delivered, installed, and tested in time for the 1988 filing season.

13. Monitor Systems Acceptability Testing through completion. Continue regular bi-weekly briefings with the A/C Computer Services.

14. Complete written responses to unresolved issues that developed during Service Center Returns Processing and Accounting Divisions presentations on tax law changes.

15. Keep Service Center management informed as developments occur relating to the implementation of the Total Evaluation Performance System (TEPS).

Taxpayer Service

1. Ensure that the telephone back-up systems (DACON) are installed timely (December) in all VEGA toll-free sites.

2. Ensure Taxpayer Service Workload projections are carefully monitored. Ensure there is trained back-up staff in all offices providing tax assistance.

3. Complete Taxpayer Service Divisions contingency plan by November 30, 1987.

4. Monitor to ensure that the moves of the Denver and Milwaukee call sites are completed for the filing season.

5. Review readiness of the three back-up Taxpayer Service Telephone Answering sites (Jacksonville, Indianapolis, and Houston).

6. Follow through in developing a new system to measure quality of responses assistors provide to taxpayers through the toll-free system.

Forms Distribution and Publication Services

1. Complete final readiness reviews of CID's sites scheduled for December.

2. Follow up to ensure the ACD System for the Bloomington CID site is installed as scheduled in December.

3. Maintain tight control and inventory systems to ensure timely completion, printing and distribution of Tax Forms and Publications. Maintain adequate inventory levels at CID sites.

4. Meet customer demand for Publication 920 including adequate inventory levels at CID sites.

Other

1. Finalize application of ES Penalty for Tax Year 87 and related notices to taxpayers. Form 2210 needs to be revised accordingly, printed, and distributed.

2. The Regions should perform readiness reviews in each Service Center and District Office Taxpayer Service function. Problems should be identified and promptly corrected. Problems beyond regional control should be promptly reported to the appropriate Assistant Commissioner.

3. Ensure necessary testing of run times for Electronic filing on the 1100 System in Cincinnati and Ogden.

4. Monitor filing preparations for electronic filing including user testing, finalizing contract with CLR Corp., and the preparation of an Electronic Filing contingency plan.

5. Monitor legislation which will extend refund offsets for government debts beyond 12/87.

6. Develop a strategy to address the potential for negative public or media reaction to the Tax Reform Act.
Examples: Forms are too complex.
Taxing minors.
Telephone demand is beyond capacity.

7. Develop an early warning system to include:
   1. What questions are taxpayers calling about?

   2. What are service center error rates and if abnormal, what are the causes?

Be prepared for an extensive publicity campaign if needed as specific problem areas are identified.

Index to Follow-up Items

Service Center

Item	Responsible Official(s)
1 -	- Assistant Commissioner, Taxpayer Service and Returns Processing - Regional Commissioners - Service Center Directors
2 -	- Assistant Commissioner, Taxpayer Service and Returns Processing
3 -	- Assistant Commissioner, Taxpayer Service and Returns Processing
4 -	- Assistant Commissioner, Taxpayer Service and Returns Processing - Assistant Commissioner, Human Resources Management and Support
5 -	- Assistant Commissioner, Taxpayer Service and Returns Processing
6 -	- Assistant Commissioner, Taxpayer Service and Returns Processing - Assistant Commissioner, Computer Services
7 -	- Assistant Commissioner, Taxpayer Service and Returns Processing
8 -	- Assistant Commissioner, Computer Services
9 -	- Assistant Commissioner, Computer Services
10 -	- Assistant Commissioner, Computer Services
11 -	- Assistant Commissioner, Computer Services
12 -	- Assistant Commissioner, Computer Services - Assistant Commissioner, Human Resources Management and Support
13 -	- Assistant Commissioner, Computer Services
14 -	- Assistant Commissioner, Taxpayer Services and Returns Processing
15 -	- Assistant Commissioner, Taxpayer Servies and Returns Processing

Taxpayer Service

Item	Responsible Official(s)
1 -	- Assistant Commissioner, Taxpayer Service and Returns Processing - Assistant Commissioner, Human Resources Management and Support
2 -	- Assistant Commissioner, Taxpayer Services and Returns Processing - Regional Commissioners - District Directors
3 -	- Assistant Commissioner, Taxpayer Service and Returns Processing
4 -	- Assistant Commissioner, Taxpayer Service and Returns Processing - Assistant Commissioner, Human Resources Management and Support
5 -	- Assistant Commissioner, Taxpayer Services and Returns Processing
6 -	- Assistant Commissioner, Taxpayer Services and Returns Processing

Forms Development and Publishing Services

Item	Responsible Official(s)
1 -	- Assistant Commissioner, Human Resources Management and Support - Regional Commissioner - Mid-Atlantic, Mid-West and Western
2 -	- Assistant Commissioner, Human Resources Management and Support
3 -	- Assistant Commissioner, Taxpayer Service and Returns Processing - Assistant Commissioner, Human Resources Management and Support
4 -	- Assistant Commissioner, Human Resources Management and Support

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Other

Item	Responsible Official(s)
1-	- Assistant Commissioner, Taxpayer Service and Returns Processing - Assistant Commissioner, Human Resources Management and Support - Assistant Commissioner, Computer Services
2 -	- Assistant Commissioner, Taxpayer Service and Returns Processing - Assistant Commissioner, Computer Services - Assistant Commissioner, Human Resources Management and Support - Regional Commissioenrs - Service Center Directors - District Directors
3 -	- Assistant Commissioner, Computer Services
4-	- Assistant Commissioner, Taxpayer Services and Returns Processing - Assistant Commissioner, Computer Services - Assistant Commissioner, Human Resources Management and Support
5 -	- Assistant Commissioner, Computer Services
6 -	- Assistant to Commissioner, Public Affairs
7 -	- Assistant Commissioner, Taxpayer Service and Returns Processing - Assistant to Commissioner, Public Affairs

[Submission for the record:]

John E.
Shriver & Company

March 16, 1988

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
Room 1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: Hearing on 1988 Tax Return
Filing Season

Dear Mr. Leonard:

By way of background, I am the managing partner of John E. Shriver & Co., a local CPA firm with fifteen employees. I personally have 35 years of tax experience. Our firm specializes in helping small businesses whose sales volume ranges between $1,000,000 and $40,000,000. Our typical client is owned by one or two entrepreneurs who began a business because they thought they could build a better product, or sell something better than someone else. Often, they are not accounting and finance oriented, but rely upon us to help them in these areas. We assist our clients in developing information systems that give management the necessary information from which to make business decisions; decisions that will make their businesses more profitable and competitive. However, in recent years both our clients and ourselves have had to spend more and more time on learning and complying with new tax rules, and less and less time on tasks that help the client become more profitable and competitive.

Congress has created an unbelievably complex Internal Revenue Code, followed by equally complex regulations issued by the Treasury Department. The complexities add an incredible administrative burden on small businesses. This added cost of tax compliance robs these businesses of time and money; time and money that could be better spent in increasing sales, developing new products, making the business more efficient, etc. This additional burden is completely nonproductive; it did not enable the business to produce one more "widget". For a country that has been concerned about its productivity, it seems strange to place this burden upon the economy.

Some examples of the complexities:

Depreciation:

The way in which depreciation is determined has been changed four times since 1980. And, beginning with the year 1987, depreciation for each asset must be calculated a minimum of three different ways for Federal tax purposes: regular tax, alternative minimum tax, and adjusted current earnings. Different lives; and different methods of computing the depreciation are required for each purpose. In addition, there is the half-year convention, the modified half-year convention, the mid-quarter convention, and the mid-month convention.

3220 Carew Tower Cincinnati, Ohio 45202 (513) 241-1149
A Professional Service Corporation

Uniform Capitalization of Inventory Costs:

The Uniform Capitalization of Inventory rules place an additional administrative burden on small businesses. Essentially, the effect of Uniform Capitalization is a one-time increase in tax revenue. Yet the burden of complying with these complex rules is an on-going, costly exercise for the taxpayer. The cost of complying with these rules, in many cases, exceed the additional revenue to the Government. And again, their is no benefit to the business.

Passive Activities:

These most complex rules are now being followed by yet more complex regulations, as witnessed by the "first phase" regulations published February 19, 1988, consisting of 268 pages. These 268 pages address only the issue of whether a participant is a "material participant". Moreover, these just-issued regulations are to be applied to the filing of 1987 tax returns which are due April 15, 1988, less than two months after their issuance, and during a tax season when practitioners already are overburdened.

Interest Expense Allocation:

Taxpayers must now determine if their interest expense is investment interest, trade or business interest, passive activity interest, home mortgage interest, or personal interest. Once this is done, the taxpayer must then apply differing limitations to each type of interest. The Revenue Act of 1987 has already modified the definition of home mortgage interest which was first defined in the Tax Reform Act of 1986.

Alternative Minimum Tax:

This provision requires that virtually every taxpayer compute his tax two different ways. He must maintain two separate sets of records to determine his cost basis for tax purposes. When he sells the property, he could have a gain for regular tax purposes, but a loss for alternative minimum tax purposes. In addition, when there are net operating losses, there two different amounts allowed as carrybacks or carryforwards.

Kiddie Tax:

This tax on children under age 14 adds a complexity which I doubt justifies the additional revenue to the government.

Confusion of Tax Preparers:

An article in Money, March, 1988, by Greg Anriz, Jr. entitled "Even Seasoned Pros Are Confused This Year" details how tax return information for a hypothetical family was sent to fifty, experienced tax preparers. The response, was fifty different amounts of tax due from the family. It is not surprising that no two preparers reached the same conclusion. See Appendix A

Confusion by the IRS:

The Wall Street Journal of February 18, 1988, had an article by Rose Gutfeld. This article reviews the results of four questions posed to five IRS offices. The IRS answered only 30% of these questions correctly. Yet, an IRS spokeswoman is quoted as saying they "did a pretty good job". See Appendix B

Deduction of Points on a Mortgage Loan:

An article entitled "Points on Home Mortgage Loans", The Tax Adviser, March, 1988 contains thirteen pages, and includes a two-page flowchart which details the decisions that must be made before deducting points paid on a mortgage. All this for something that should be a simple decision. This does not involve sophisticated investors or tax shelter promoters. This involves your ordinary, taxpaying homeowner. See Appendix C

A Tax System Out of Control:

An article appearing in the February, 1988 issue of the Journal of Accountancy by Arthur Lodge is entitled "A Tax System Out of control". Mr. Lodge states that in many cases it is impossible to comply with recent tax laws because the Treasury regulations explaining what was really meant don't appear for many years - if ever. And, when they are released, these regulations often arrive in the form of 50 to 80 pages of fine print that further obfuscates rather than clarifies. See Appendix D

The Tax Reform Act of 1986 was passed on October 18, 1986. Included in this comprehensive act of 925 pages were provisions for certain elections that had to be made by December 31, 1986, or be lost forever. This was most unfair to taxpayers and to tax advisors. To expect them to digest this complex tax law (that has been categorized as the most extensive overhaul of the U.S. tax code in almost 40 years), and to formulate an opinion on these elections in such a short period of time, was most inappropriate.

Congress, by passing tax laws without due deliberation, and by authorizing the Treasury Department to interpret these laws by issuing regulations to which Congress has no input, has shirked its responsibilities. Our tax system is based upon voluntary compliance, but taxpayers can only comply if they understand the rules. Consequently, unless Congress acts to ease the chaotic condition of our tax system, I predict the system will crumble from its own weight. Furthermore, unless Congress reverses the trend toward requiring the use of more nonproductive man-hours, our country's productive capacity will continue to decline.

Very truly yours,

Philip L. Shriver

Philip L. Shriver, CPA

mjs
enclosures

TAXES

Even Seasoned Pros Are Confused This Year

by Greg Anrig Jr.

MONEY asked 50 tax preparers to figure one family's taxes—and got 50 different answers.

Chances are that if you've mustered the courage to look at this year's "simplified" 1040 tax packet, you are probably ready to seek professional help—either from a tax preparer or a mental-health therapist. The tax reform law has added new complexity to the old forms while creating another whole set of befuddling worksheets for you to complete. So if you have any itemized deductions at all, you should probably see a tax practitioner. But beware: the pros are plenty baffled themselves.

A MONEY examination of 50 tax preparers nationwide shows that the new tax law is causing all sorts of problems for those who make their living filling out tax returns. What's more, an easier test we conducted reveals that the IRS' own taxpayer assistors are alarmingly ignorant about the revised tax code (see the box on page 136).

In January, MONEY mailed the financial profile of a hypothetical family to the participants in our project, who agreed to prepare the family's tax returns based on the information sent. (They were also encouraged to call us if they needed additional information.) Formulated with the help of S. Theodore Reiner, senior manager with the Washington, D.C. office of Ernst & Whinney, the profile raised complex tax issues relating to the new law, but included no unfair trick questions. Here are the most striking results of our survey:

▸ The 50 pros computed 50 different amounts of tax due from the family. Their bottom lines varied by as much as 50%.

▸ The preparers are still uncertain about the nuances of the new tax law.

▸ In cases where the law itself is unclear, the pros are making up rules of their own that differ greatly. Because there are an unprecedented number of gray areas, it's more likely than ever that you could end up paying a higher tax bill—or risking an audit—with some practitioners than with others.

▸ Pro tax preparers, even the most expensive ones, are not immune from making careless mathematical mistakes.

▸ H&R Block outlets are capable of handling a difficult return as skillfully as some Big Eight firms—at a fraction of the cost. While the Block preparers would have charged an average of only $267 to our hypothetical family, the national accounting firm's fees averaged $1,567.

Originally, we sent our hypothetical case to 60 practitioners. Fifteen were chosen from each of four categories: certified public accountants with national offices, who charge anywhere from $50 to $250 an hour; C.P.A.s with local or regional firms, who on average charge slightly lower rates; enrolled agents—independents who have either worked for the IRS as revenue agents for at least five years or passed a two-day IRS test—who charge between $50 and $150 an hour; and H&R Block preparers, who charge $8 to $24 per tax form—which works out to $50 for a typical return. Nationwide, there are about 375,000 C.P.A.s, 40,000 H&R Block preparers and 24,000 enrolled agents. Of the 96.1 million personal tax returns filed in the U.S. for 1986, about 44.1 million—or 46%—were filled out by professional preparers.

Fifty of the 60 practitioners who agreed to take MONEY's test sent back completed 1040 forms to us within two weeks as promised. Seven C.P.A.s with national firms and three H&R Block preparers backed out, in most cases claiming that they didn't have enough time. Because the law is imprecise about several matters pertaining to the hy-

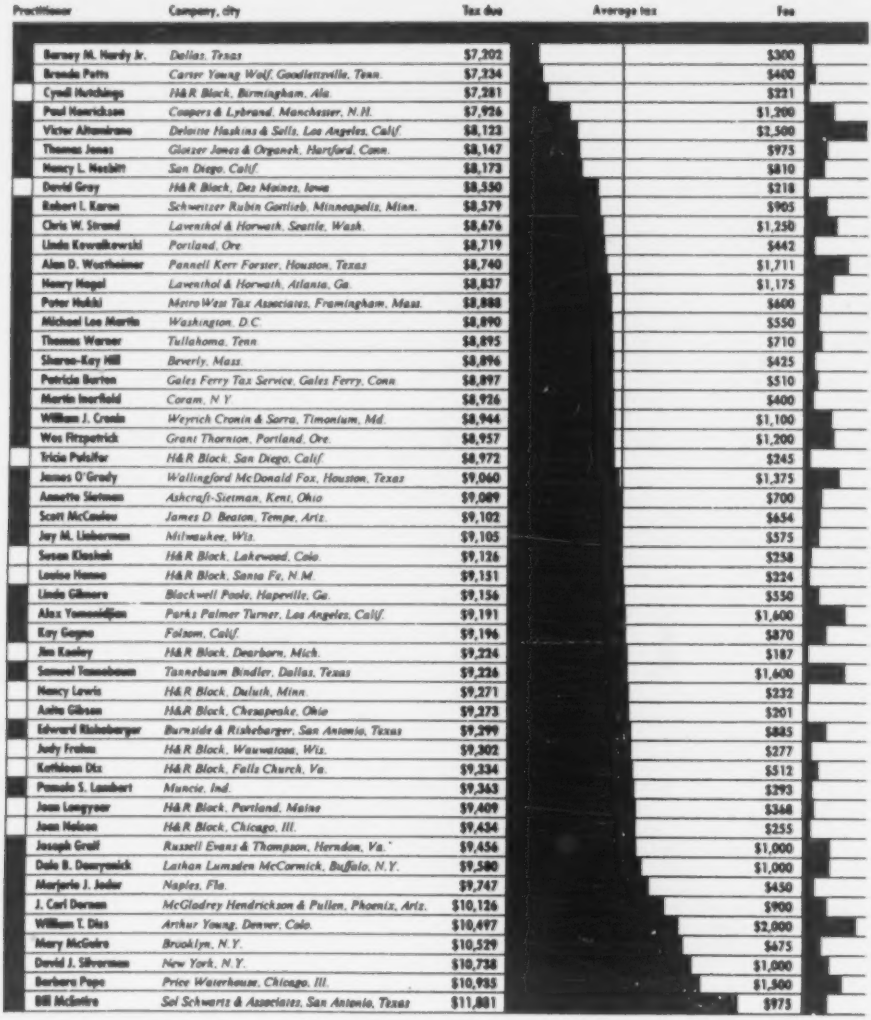
Jim Keeley, an H&R Block district manager in Dearborn, Mich., would have charged the lowest fee—only $187—to fill out our test return. Better yet, he didn't make any mistakes.

ANNA SUTO

More than ever, the tax preparer makes all the difference

The 50 tax practitioners—of four types—who completed returns for our hypothetical family came up with different tax totals—and fees. The average tax (black line) was $9,105, but the returns ranged from $7,202 to $11,881. The average fee was $779, but it varied from $187 to $2,500.

■ National C.P.A.s ☐ H&R Block
■ Local C.P.A.s ■ Enrolled agents

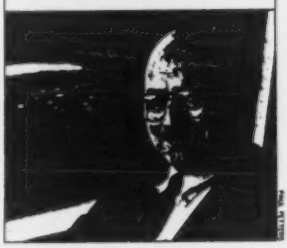


Practitioner	Company, city	Tax due	Fee
Barney M. Hardy Jr.	*Dallas, Texas*	$7,202	$300
Brenda Potts	*Carter Young Wolf, Goodlettsville, Tenn.*	$7,234	$400
Cyndi Hutchings	*H&R Block, Birmingham, Ala.*	$7,281	$221
Paul Hewrickson	*Coopers & Lybrand, Manchester, N.H.*	$7,926	$1,200
Victor Altamirano	*Deloitte Haskins & Sells, Los Angeles, Calif.*	$8,123	$2,500
Thomas Jones	*Glaizer Jones & Organek, Hartford, Conn.*	$8,147	$975
Nancy L. Nesbitt	*San Diego, Calif.*	$8,173	$810
David Gray	*H&R Block, Des Moines, Iowa*	$8,550	$218
Robert I. Karon	*Schweitzer Rubin Gottlieb, Minneapolis, Minn.*	$8,579	$905
Chris W. Strand	*Lavenithol & Horwath, Seattle, Wash.*	$8,676	$1,250
Linda Kowalkowski	*Portland, Ore.*	$8,719	$442
Alan D. Westheimer	*Pannell Kerr Forster, Houston, Texas*	$8,740	$1,711
Henry Nagel	*Lavenithol & Horwath, Atlanta, Ga.*	$8,837	$1,175
Peter Hokki	*MetroWest Tax Associates, Framingham, Mass.*	$8,888	$600
Michael Lee Martin	*Washington, D.C.*	$8,890	$550
Thomas Warner	*Tullahoma, Tenn.*	$8,895	$710
Sharon-Kay Hill	*Beverly, Mass.*	$8,896	$425
Patricia Burton	*Gales Ferry Tax Service, Gales Ferry, Conn.*	$8,897	$510
Martin Inorfield	*Coram, N.Y.*	$8,926	$400
William J. Cronin	*Weyrich Cronin & Sorra, Timonium, Md.*	$8,944	$1,100
Wes Fitzpatrick	*Grant Thornton, Portland, Ore.*	$8,957	$1,200
Tricia Pulsifer	*H&R Block, San Diego, Calif.*	$8,972	$245
James O'Grady	*Wallingford McDonald Fox, Houston, Texas*	$9,060	$1,375
Annette Sietman	*Ashcraft-Sietman, Kent, Ohio*	$9,089	$700
Scott McCauley	*James D. Beaton, Tempe, Ariz.*	$9,102	$654
Jay M. Lieberman	*Milwaukee, Wis.*	$9,105	$575
Susan Klashak	*H&R Block, Lakewood, Colo.*	$9,126	$258
Louise Hanna	*H&R Block, Santa Fe, N.M.*	$9,151	$224
Linda Gilmore	*Blackwell Poole, Hapeville, Ga.*	$9,156	$550
Alex Yemenidjian	*Parks Palmer Turner, Los Angeles, Calif.*	$9,191	$1,600
Kay Gegna	*Folsom, Calif.*	$9,196	$870
Jim Kaskey	*H&R Block, Dearborn, Mich.*	$9,224	$187
Samuel Tannebaum	*Tannebaum Bindler, Dallas, Texas*	$9,226	$1,600
Nancy Lewis	*H&R Block, Duluth, Minn.*	$9,271	$232
Anita Gibson	*H&R Block, Chesapeake, Ohio*	$9,273	$201
Edward Rishebarger	*Burnside & Rishebarger, San Antonio, Texas*	$9,299	$885
Judy Frahm	*H&R Block, Wauwatosa, Wis.*	$9,302	$277
Kathleen Dix	*H&R Block, Falls Church, Va.*	$9,334	$512
Pamela S. Lambert	*Muncie, Ind.*	$9,363	$293
Joan Longyear	*H&R Block, Portland, Maine*	$9,409	$368
Joan Nelson	*H&R Block, Chicago, Ill.*	$9,454	$255
Joseph Grall	*Russell Evans & Thompson, Herndon, Va.*	$9,456	$1,000
Dale B. Dewrynnick	*Lathan Lumsden McCormick, Buffalo, N.Y.*	$9,580	$1,000
Marjorie J. Jodar	*Naples, Fla.*	$9,747	$450
J. Carl Doreen	*McGladrey Hendrickson & Pullen, Phoenix, Ariz.*	$10,126	$900
William T. Diss	*Arthur Young, Denver, Colo.*	$10,497	$2,000
Mary McGuire	*Brooklyn, N.Y.*	$10,529	$675
David J. Silverman	*New York, N.Y.*	$10,738	$1,000
Barbara Pope	*Price Waterhouse, Chicago, Ill.*	$10,935	$1,500
Bill McEntire	*Sol Schwartz & Associates, San Antonio, Texas*	$11,881	$975

pothetical case, there was no right or wrong bottom-line answer. (No withholding was assumed, for simplicity's sake.) Ernst & Whinney's Reiner, who helped us develop the hypothetical case, anticipated that the typical response would be around $9,000. He was right on the money: the actual average turned out to be $9,105. But the final tax due that the preparers came up with spanned an enormous range, from a low of $7,202 all the way up to $11,881. Of the 50 participants, 16 computed a tax that differed from the $9,105 average by more than $500. (Each participant's fee and bottom line is listed in the table on page 135.)

The factor most responsible for the wide variation in the responses was the new, more complicated version of the alternative minimum tax, which will affect more taxpayers than in previous years but still less than 1% of all personal returns. The AMT, as it's called, is a tax computed separately from the 1040 form that prevents taxpayers with sizable deductions from paying very little to the government. Many, but not all, of the preparers who came up with a low tax due simply miscalculated the AMT by omitting an important figure.

"The preparers found many ways to deal with the same problem."



S. Theodore Reiner, senior manager with Ernst & Whinney, helped MONEY design the hypothetical tax case that the pros tackled.

Five of the preparers who computed an unusually high tax bill did so because they assumed—quite reasonably—that a technical corrections bill containing an important AMT change will soon become law retroactive to 1987. Because their fees are relatively high, the five could save their clients as much as $700 by eliminating the need for an amended return after the bill passes. In the meantime, however, the hypothetical family would owe a tax that is $1,596 higher than it would be under the law as it now stands. The lesson: if your preparer tells you that you are subject to the AMT, make sure he spells out the costs and benefits of figuring your return under both the current and the corrected rules.

In addition to the AMT, there were three other important reasons for variations in tax calculations. First, some preparers were unfamiliar with the tax code's finer points. A problem in the hypothetical case involving an excess contribution to a 401(k) retirement plan, for example, stumped six

Testing the IRS

SO HOW COME THE IRS KNOWS ALL THE ANSWERS WHEN YOU GET AUDITED?

When the General Accounting Office examined the IRS telephone assistance program a year ago, it found that the agency answered only 79% of the GAO's questions correctly. The IRS vowed to do better this year and has launched a major public relations campaign promising to "put the service back in The Service." It's a nice thought. But a MONEY survey conducted this past January—using easier questions than those we asked of the tax practitioners—suggests that the IRS "helpers" have gotten *worse*. In fact, the assistors were right only slightly more than half the time. Forty percent of those we queried, for example, didn't even know that the IRS itself, with great public fanfare, had waived the penalty on tax underpayments for workers who had too little withheld from their paychecks last year. Maybe the IRS should call H&R Block.

MONEY placed a total of 100 calls to IRS assistors. Each helper was asked one of 10 questions, prepared with the help of Ernst & Whinney, and each question was posed to 10 different assistors. The results were appalling. Overall, only 55 responses were correct and 45 were inaccurate. In four cases, the assistors said that additional research was needed and that a written response would be sent within eight working days. Did research help? No way. All four written answers were wrong.

Spokesperson Johnelle Hunter defends the IRS by saying that MONEY's questions were "not typical." Larry Endy, the director of the GAO's study, says the IRS made the same claim last year. Says he: "We asked questions that we thought the IRS people should be able to answer whether they received them 10 times or a million times." So did MONEY.

The assistors were most knowledgeable about the new kiddie tax (MONEY, February 1988) and the reduction in basic deductions for such expenses as union dues. All the representatives we asked knew that a 13-year-old child with $100 in bank interest and $700 in paper route income must file a 1987 tax return. And nine of 10 correctly responded that miscellaneous deductions, including union dues, can be written off only to the extent that their total exceeds 2% of adjusted gross income.

But 60% were not aware that the cost of sending a child to an overnight summer camp can be counted toward the child-care credit in 1987. Also, seven of 10 didn't know that interest paid on a loan used to buy tax-exempt bonds is not deductible.

In the wake of last year's GAO report, the IRS hired 1,000 more assistors, bringing the total to 4,500. The service also expanded its training sessions for telephone representatives and required its supervisors to monitor more phone calls. In addition, to solve last year's problem of constant busy signals, the number of phone lines has been expanded by 30%. Unfortunately, despite those efforts, IRS helpers remain woefully ill-informed about the new tax law. —*G.A. Jr.*

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Selective Service/Send Your Male To The Post Office
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TAXES

Thirteen of our participants made math errors or other outright blunders.

participants. In addition, almost half of the practitioners were unfamiliar with new provisions enacted last December concerning mutual fund expenses and master limited partnership income. The errors in such instances involved small dollar amounts, though similar mistakes on your return could conceivably cost you a lot of money. We did not count as errors cases in which participants made assumptions on their own that justified a different answer. These independent assumptions caused some minor variations in the bottom lines.

Mathematical mistakes or blatant oversights were the second main reason for differing tax calculations. Thirteen of our participants—five local C.P.A.s, three enrolled agents, three Block preparers and two C.P.A.s with national firms—made errors that could be characterized as blunders. The lesson: always review each line of your completed return with your preparer. If he seems vague or uncertain about a particular item, have him show you the pertinent tax code provision or regulation. Remember, if you are ever audited, you—not your tax preparer—will be the one subject to back taxes, interest and penalties.

The final major cause for differing bottom lines is the gaps in the tax law itself. For some situations, there are no clear rules. In our hypothetical cases, the preparers had to cope with such ambiguities to determine the family's interest and miscellaneous deductions. Aggressive preparers tried to save as much tax for the family as they could justify. But in so doing, they increased the risk that the IRS would audit the family's return. Conservative preparers were more inclined to let the family pay higher taxes. Our participants were split fairly evenly between these two philosophies. C.P.A.s with national or local firms tended to be either very aggressive or very conservative. The enrolled agents and H&R Block preparers were apt to be middle of the road.

Not surprisingly, the C.P.A.s, who by and large serve wealthy individuals and corporate clients, charged fees that far exceeded those of the other preparers. The average bill was $1,567 for those at national accounting firms and $966 for the local C.P.A.s. In contrast, enrolled agents and H&R Block preparers, who cater to taxpayers of modest means, charged an average of $582 and $266, respectively. The average tax bill that they calculated for the family was slightly lower than the amount that the C.P.A.s computed: $9,076 for the enrolled agents and $9,027 for the H&R Block preparers, compared with $9,086 for the national C.P.A.s and $9,205 for the local ones.

One reason for their high fees is that C.P.A. firms generally offer much more sophisticated year-round tax-planning services. In fact, many C.P.A.s who participated sent along tax-planning tips for the hypothetical family with their tax returns, even though we didn't ask for any. In some cases, their ideas would have saved the family more than the $2,500 that the most expensive C.P.A. charged. No enrolled agent or Block preparer included planning points.

The performance of the relatively inexpensive H&R Block preparers was quite good. Considering that the hypothetical family's finances were far more complex than those of the typical Block client, the chain provided excellent value. Many of the Block participants consulted the firm's eight-person troubleshooting team in the firm's home office in Kansas City to ask about particular changes in the law, a step that preparers in branch offices often take if a client has a complicated problem.

A group of five enrolled agents came up with bottom lines that were within $9 of one other, an aberration considering how widely the other responses varied. Patricia Burton of Gales Ferry, Conn., one of the five, explains that she and several of the others discussed some of the more challenging aspects of the case. A former president of the 6,000-member National Association of Enrolled Agents, Burton says she frequently consults with other enrolled agents about her client's tax problems. Because there are relatively few enrolled agents, the group tends to be more closely knit than other professional preparers, she says.

Some of the most interesting results of our test pertain to the specifics of our hypothetical case. The profile we sent describes the Johnsons, a couple earning a combined salary of $100,000 with three children, each

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TAXES

of whom earned enough in 1987 to be subject to tax. The family's investments included stocks, corporate and municipal bonds, mutual funds, limited partnerships and U.S. Savings Bonds and Treasury bills. The Johnsons moved during the year and kept a second home, which they rented out part of the time. To complicate things further, they also took out a second mortgage on the second home. After reviewing the returns, Ernst & Whinney's Reiner said that aside from the AMT, the area that posed the biggest problem was the mortgage interest deduction on the second home. Says he: "Calculating the AMT and the interest deductions was brutal."

Here, from the top of the tax return to the bottom, is a summary of how the preparers computed the Johnson family's taxes:

SALARIES, INTEREST AND DIVIDENDS

Aside from a couple of mathematical errors, the practitioners generally had little trouble with this section. One exception: six preparers failed to report as taxable interest $125 that was earned on an excess 401(k) contribution the wife made. Several others also didn't count the money but made assumptions on their own that justified the omission.

CAPITAL GAINS

On this line, 20 practitioners incorrectly counted $400 in mutual fund fees as taxable income. They would have been correct before December, but since then Congress has passed a bill saying that such so-called phantom income should not be counted as income in 1987.

LOSSES FROM LIMITED PARTNERSHIPS

Another 21 of our participants, some of whom knew about the mutual fund fee change, missed a different provision in the December tax bill. They were not aware that tax-shelter losses cannot be used to offset fully income from a master limited partnership, a type of partnership that is publicly traded like a stock—a fact that some of our practitioners didn't know.

STATE AND LOCAL TAXES

Here, only a couple of preparers made an error. Nevertheless, the responses differed. Forty-four of our participants aggressively followed a 1983 appellate court ruling to determine the deduction while six adhered to more conservative IRS rules. The issue con-

cerned the amount of property-tax expense on the family's second home that could be deducted on Schedule A, their itemized deduction form. The IRS and the court disagree about the proper way of allocating expenses between personal and rental use when a second home is rented out part of the time. Using the court ruling formula added $150 to the Johnsons' personal property tax write-off compared with the IRS approach.

INTEREST DEDUCTIONS

For this write-off we received 49 different answers. The preparers essentially had no guidelines because the IRS hasn't yet written final regulations explaining how to deduct interest on a second mortgage on a second home that is leased out part of the year. Because the second mortgage was used for personal expenses and exceeded the original cost of the property, not all the mortgage interest was deductible. The most aggressive of our participants ended up writing off a total $21,022 in interest, while the most conservative deducted only $17,320. Most of the responses ranged between $18,100 and $18,900.

MISCELLANEOUS DEDUCTIONS

Here, 38 preparers deducted a conservative amount while 12 were more aggressive. The controversy related to a four-year subscription to a trade publication that cost $200. Following IRS regulations, the conservative practitioners deducted only one-fourth of the $200. The others wrote off the full amount, explaining that there's no law actually prohibiting the $200 write-off. In an audit, the extra $150 would most likely be disallowed, which would leave it up to the Johnsons and their preparer to decide whether to take their case to tax court. Considering the small amount, they would probably just pay up.

The results of our project are anything but reassuring. They provide a graphic warning to all taxpayers during this filing season: don't sign your return until you have carefully scrutinized every line. That's true whether you filled out the forms yourself or hired the most expensive accountant in town. But don't hesitate to hire someone to do the job for you. Despite the problems they had with our hypothetical case, the majority of the pros proved that they can save taxpayers a lot of anguish, and maybe even a fair amount of money. $

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WSJ - 2/18/88 "APPENDIX B"

IRS Staffers Are Ready to Assist Taxpayers, but Not Always Able

YOUR MONEY MATTERS

By Rose Gutfeld
Staff Reporter of The Wall Street Journal

Taxpayers struggling with the new income tax law and returns due April 15 are finding a beefed-up Internal Revenue Service staff ready to assist them.

Unfortunately, the IRS workers frequently give incorrect answers to complicated questions.

To test the agency's ability to help taxpayers with the new law, The Wall Street Journal devised four questions with help from the accounting firms of Touche Ross & Co. and Price Waterhouse. Each question was asked over the telephone of five IRS offices. Although the questions are complicated, the accounting firms say they are typical of the types of queries many taxpayers have about the new law.

If so, taxpayers should be wary. Questions about individual retirement accounts, mortgage-interest deductions and investment-interest deductions drew more incorrect answers than accurate ones. The offices answered just one question with complete accuracy—a query about when children need to file a return.

IRS Commissioner Lawrence Gibbs contends that the agency is better prepared than ever to field taxpayer questions. It boosted its taxpayer service staff by 1,000 this year to 4,500 and increased the number of phone lines by 24%. The IRS also began hiring and training taxpayer service employees earlier than in previous years.

But this expanded crew is pitted against a sweeping tax-law change that has brought new rules, longer forms and more difficult instructions.

Below are the Journal's questions, the correct answers from IRS headquarters, and a description of how the field offices answered the queries.

QUESTION 1

My husband earned $36,500 in 1987, and I made $13,000. He is covered by a pension plan at work; I am not. Are we allowed an IRA deduction; if so, how big?

WHAT THEY SHOULD HAVE SAID: You can each make a tax-deductible contribution of $200 for a total contribution of $400 on a joint return. The ability to make deductible contributions to IRAs phases out at $50,000 in income for married couples filing jointly. A worksheet accompanying the 1040 form instructs each spouse to take 20% of $500, the amount of their joint income below $50,000. Although that gives $100, there is a minimum $200 deductible contribution per person.

WHAT THEY DID SAY: Staffers in IRS field offices all knew that the couple could get a partial deduction and that $50,000 was the cutoff, but nobody correctly gave the amount this couple could deduct. Two people incorrectly said the couple's total deductible contribution was $100, and two put it at $200. The fifth referred a caller to the proper worksheet but didn't say what the deductible contribution would be.

The confusion could have occurred because the IRS employees didn't realize that the minimum deductible contribution is $200 a person or that the IRA worksheet accompanying the 1040 form must be filled out by each spouse who contributes.

Even Touche Ross, which provided the question, initially put the couple's total deduction at $200 rather than $400.

QUESTION 2

I took out an $80,000 mortgage to buy a house for $100,000 in 1980. In January 1987, the house was reappraised for $125,000. The loan, which had been paid down to $75,000, was refinanced so that it totaled $110,000. After paying off the first loan, I used $5,000 of the proceeds for home improvement and $30,000 for a new car. The average balance on the loan was $109,000 last year, and I paid $10,000 in interest. How much of the interest is deductible?

WHAT THEY SHOULD HAVE SAID: You may deduct $9,600 as mortgage interest and $260 as personal interest. To arrive at that, use Form 8598 and multiply the amount of interest paid ($10,000) by the ratio of the qualified loan limit (in this case the home's purchase price plus improvements, or $105,000) to the average balance of the debt ($109,000). This produces deductible mortgage interest of $9,600 after rounding. The other $400 of interest paid is treated as personal interest, and 65% of it, or $260, can be deducted.

WHAT THEY DID SAY: An IRS woman in Des Moines, Iowa, said all the interest is fully deductible. At the Denver office, a woman said that the portion used to buy the car couldn't be deducted at all and that the rest would be partly deductible as personal interest. The three other staffers said a portion couldn't be deducted, but only a man in Dallas correctly said that the limit would be based on the home's purchase price plus improvements. One employee directed the caller to an incorrect form.

QUESTION 3

Last year I earned $800 in interest and dividends on assets in a cash-management account at my brokerage firm. In May, I borrowed from the account to buy stock and during 1987 paid $900 in interest on the loan. How much is deductible?

WHAT THEY SHOULD HAVE SAID: You can deduct $865 of investment interest expense. The interest on the loan to buy stock is fully deductible up to the amount of your investment income. That means $800 (the amount that corresponds to the interest and dividend income) of the $900 can be fully deducted. Of the remaining $100 in interest expense, $65 can be deducted, under a provision that allows taxpayers to deduct 65% of as much as $10,000 of investment interest expense over their investment income.

WHAT THEY DID SAY: Employees in Richmond, Va.; Boston; Los Angeles and Nashville, Tenn., incorrectly said that all the interest would be 65%-deductible as a personal loan. A woman in Chicago said she thought the interest would be investment interest but wasn't sure and recommended an IRS publication.

QUESTION 4

My 15-year-old son earned $600 from a summer job in 1987 and has a small savings account that earned $100 of interest during the year. Is he required to file a 1987 tax return? If so, can he take a personal exemption for himself on his return, if I claim him as a dependent?

WHAT THEY SHOULD HAVE SAID: Your son must file. The 1986 law requires any dependent with total income over $500 and any income from interest, dividends or other unearned sources must submit a return. He can't claim a personal exemption on his return if he can be claimed as a dependent on another person's return.

WHAT THEY DID SAY: All responses from the field offices were accurate.

Commenting on all the questions, an IRS spokeswoman says employees "did a pretty good job for this time in the filing season." She adds: "We know this is going to be a learning-curve year for us."

Robert LeBaube, director of taxpayer service, says the IRS's own test calls have found employees needing more guidance on rules affecting IRAs and mortgage and interest deductions. He also says that initial results suggest that the agency may have given insufficient emphasis to "old stand-by things" such as child-care credits and deductions for dependents.

As of Feb. 12, the IRS had answered about 5.8 million calls, compared with 5.4 million a year earlier. The IRS will waive penalties that taxpayers can demonstrate were assessed as a result of erroneous information received from IRS employees, and Mr. Gibbs says the agency is looking into whether it can waive any interest owed, too. But it's difficult to prove that errors resulted from IRS mistakes.

Points on Home Mortgage Loans

Deductibility in the Year of Refinancing

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Record numbers of taxpayers are refinancing their personal residences with mortgage instruments bearing a lower interest rate in order to reduce their monthly payments and to extinguish other consumer debt.[1] A common belief held by many taxpayers is that "points" associated with home mortgage transactions are fully deductible on their current tax returns. The IRS, however, has taken the position that the current deductibility of points depends on the circumstances surrounding a mortgage transaction.[2] This article will describe the circumstances under which points are (or are not) deductible as interest and the timing of those deductions.

Points as Interest

The various charges generally associated with a mortgage instrument include interest points, loan origination fees, commitment fees and charges for a variety of services. Some of these costs are considered interest charges while others are not. As a general rule, fees charged for the use of money are classified as interest, while fees charged for services rendered are not. Interest points are charges made by lending institutions that increase the effective interest rate paid by the borrower on new or refinanced indebtedness. The amount is generally expressed as a percentage of the loan principal amount and paid at the time of the loan closing.

Example 1: An individual obtains a loan of $60,000 secured by his principal residence. The lender may offer the borrower a choice between two mortgage instruments, one bearing an interest rate of 11% with no points, and another bearing an interest rate of 10% with three points. Under the second option, the borrower would be required to pay $1,800 ($60,000 × 0.03) as points at the time of the loan closing.

The courts have repeatedly held that amounts paid, by whatever name called (i.e., points or origination fees), for the use or forbearance of money qualify as interest. For example, the Tax Court has held that a negotiated bonus or premium that is withheld from the borrowed amount by the lender is interest paid on borrowed capital.[3] To be classified as interest, points must be paid "solely for the use or forbearance of money."[4] Any amounts paid for services rendered by the lender are not considered interest.[5] Items for which payment is not considered interest include appraisal fees, charges for credit investigations, recording fees, inspection fees and other charges for services rendered.

When points are charged partially for the use or forbearance of money and partially for services rendered, a question arises concerning the amount, if any, that may be considered interest. The Tax Court has ruled that the value of the services rendered must be subtracted from the total amount paid in points, but that the remainder is considered interest.[6] This position, however, is conditioned on whether the value of the services rendered can be determined. If the value of the services cannot be determined, the entire amount of points is considered a charge for services. Thus, the fact that a portion of the amount paid as points is remuneration for services rendered does not pre-

[1] See, e.g., "Mortgage Lenders Brace for a New But Smaller Wave of Applications," *The Wall Street Journal* (3/18/87), at 33;1, and "The Closing," *The Wall Street Journal* (9/18/86), at 1,5.
[2] Rev. Rul. 87-22, IRB 1987-14, 41.
[3] *L-R Heat Treating Co.*, 28 TC 894 (1957); *Court Holding Co.*, 2 TC 531 (1943), acq. 1943 CB 5.
[4] Rev. Rul. 69-188, 1969-1 CB 54.
[5] Rev. Rul. 67-297, 1967-2 CB 87.
[6] *Donald L. Wilkerson*, 70 TC 240 (1978).

clude classifying as interest the portion that is not for the performance of services. However, the separation of the service charges is of paramount importance.

Whether commitment fees are defined as interest depends on the circumstances of the transaction. A commitment fee is a charge made by a lending institution for an agreement to make a loan at a future date. When the borrower pays a loan commitment fee to the lender, the charge is considered to be a service fee.[7] On the other hand, when a loan commitment fee is paid by the lending institution to a purchaser of the mortgage (e.g., FNMA) and deducted from the proceeds to the borrower, the fee may be treated as interest by the borrower.[8]

Deductibility of Interest

Under Sec. 163, before it was amended by the Tax Reform Act of 1986 (TRA), cash-basis taxpayers were allowed to claim deductions for interest paid. The TRA added subsection (h), which phases out the deduction of personal interest but allows the deduction of "qualified residence interest."[9] Sec. 163(h)(3), as added by the TRA, defined qualified residence interest as "interest . . . paid or accrued during the taxable year on indebtedness which is secured by any property which . . . is a qualified residence of the taxpayer."

In December 1987, Sec. 163(h)(3) was amended by Section 10102(a) of the Revenue Act of 1987. The term "qualified residence interest" for tax years 1988 and thereafter means "any interest which is paid or accrued during the taxable year on—(i) acquisition indebtedness . . . or (ii) home equity indebtedness with respect to any qualified residence of the taxpayer." Under the 1986 and 1987 Tax Acts, qualified residences are the taxpayer's principal residence and one second residence.[10]

A taxpayer's principal residence is ordinarily that residence actually occupied by the taxpayer. For taxpayers with more than one residence, a question arises as to which is the principal residence. No clear statutory definition of the meaning of principal residence appears in the Code, but the regulations state that "whether or not property is used by the taxpayer as his principal residence . . . depends upon all the facts and circumstances in each case. . . ."[11] The Tax Court has cited as evidence of a principal residence the fact that "the petitioners consistently listed [the house's address] as their official address and generally conducted their financial and other affairs [in that location]."[12]

A second residence is generally a dwelling unit used by the taxpayer for personal use but not as his principal residence. The Code provides that under certain circumstances, the taxpayer is not required to actually use the second residence for a dwelling unit to be classified as a qualified residence.[13] If the residence is not rented out to others at any time during the year, the taxpayer is not required to use the residence for personal use for the purpose of deducting interest costs. If the residence is rented out for any portion of the year, the Code provides that the residence will qualify as a second residence only if the requirements of Sec. 280A(d)(1) are met.[14] Under Sec. 280A(d)(1), the taxpayer must use the residence for personal purposes for a period of time that exceeds the greater of 14 days or 10% of the time the residence is rented out.

It is important to recognize that the term "dwelling unit" is not limited to houses, condominiums and mobile homes, but may also include certain recreational vehicles. The Treasury has determined that boats, campers and motorhomes that contain "basic living accommodations such as sleeping space, toilet, and cooking facilities" meet the definition of a dwelling unit.[15] In *Loughlin*,[16] the court held that a motorhome "is clearly a mobile home within the statute." In *Haberkorn*,[17] an earlier case, the court held that a mini-motorhome may also be considered a dwelling unit as defined in Sec. 280A(f)(1)(A). The court stated that a mini-motorhome "provides a shelter and accommodations for eating and sleeping" and said that "whether a dwelling unit is primitive,

[7]Rev. Rul. 70-540, 1970-2 CB 101.
[8]Rev. Rul. 74-395, 1974-2 CB 45.
[9]TRA Section 511(b).
[10]Sec. 163(h)(4)(A)(i).
[11]Regs. Sec. 1.1034-1(c)(3)(i).
[12]*Paul J. McDowell*, TC Memo 1980-160, at 80-763–80-764.
[13]Sec. 163(h)(4)(A)(iii).
[14]Sec. 163(h)(4)(A)(i)(II).
[15]Temp. Regs. Sec. 1.163-10T(p)(3)(ii). A similar position is found in Prop. Regs. Sec. 1.280A-1(c).
[16]*John O. Loughlin*, DC Minn., 1982 (50 AFTR2d 82-5827, 82-2 USTC ¶9543).
[17]*Ronald L. Haberkorn*, 75 TC 259 (1980).

cramped, or palatial is not determinative of its . . . classification as a dwelling unit. . . ."[18]

According to Temp. Regs. Sec. 1.163-10T(p)(3)(ii), "[w]hether property is a residence shall be determined based on all the facts and circumstances, including the good faith of the taxpayer." As previously noted, Temp. Regs. Sec. 1.163-10T(p)(3)(ii) states that a residence generally includes a house, condominium, mobile home, boat or house trailer that contains sleeping space, toilet and cooking facilities. It seems clear from the language of the regulation that the Treasury requires all three accommodations for a vehicle to qualify as a residence.

What is not clear is whether the criteria require such accommodations to be permanently attached to the recreational vehicle. Prop. Regs. Sec. 1.280A-1(d)(2), Example (1), describes the situation of taxpayer *B*, who owns a boat suitable for overnight use. In the case of toilet facilities, if the facilities are part of the boat's structure, the term "suitable" is obviously satisfied. However, what about the boat that has a portable toilet on board? Will the fact that the facilities are not built-in preclude the boat from being classified as a qualified residence? On the other hand, will the mere addition of a portable toilet transform a boat or other recreational vehicle into a qualified residence? The same question may be applied to portable cooking facilities and sleeping units such as sleeping bags or camping cots.

In applying the *Haberkorn* case reasoning (i.e., size is not a determining factor for classification as a dwelling unit), small vans and camper trailers would appear to fall within the definition of a dwelling unit under Prop. Regs. Sec. 1.280A-1(c) and maybe under Temp. Regs. Sec. 1.163-10T. The taxpayer should be aware, however, that the original House version of the Revenue Act of 1987 did propose to disqualify mobile homes used on a transient basis, and boats, as a second residence.[19] Surprisingly, the Conference agreement did not contain this particular provision.

A final question concerns whether interest costs incurred during the period of construction of a new home meet the criteria for qualified residence interest. Under pre-1987 law, Sec. 163(h)(3)(A) specified that the property must be a qualified residence at the time the interest is accrued or paid. A structure under construction is not generally habitable as a residence until it is substantially complete. Thus, it appears that interest incurred during the period of construction of a residence was not deductible as qualified residence interest in 1987.

Revenue Act Section 10102(a) amends Sec. 163(h)(3) to include any interest that is paid or accrued during the tax year on acquisition indebtedness. Sec. 163(h)(3)(B)(i) defines acquisition indebtedness as any indebtedness "incurred in acquiring, constructing, or substantially improving any qualified residence . . . and . . . secured by such residence." On first reading, it would appear that Congress wanted to allow interest incurred or paid during the construction of a qualified residence to be deductible as qualified residence interest. However, the stipulation that the indebtedness be secured by the residence seems to disallow the deduction. Indebtedness during construction generally is not secured by the residence. Consequently, it seems that Sec. 163(h)(3)(B), as written, does not allow interest accrued or paid during construction of a residence to be deductible as qualified residence interest. On the other hand, the temporary regulations permit a taxpayer to "treat a residence under construction as a qualified residence for a period of up to 24 months, but only if the residence becomes a qualified residence . . . as of the time that the residence is ready for occupancy."[20] Assuming this part of the temporary regulations is retained, it would seem that construction interest will be deductible.

Timing the Deduction for Points

In general, for a cash-basis taxpayer, interest deductions are allowed in the year in which the tax deductible interest is paid.[21] However, the amount of the deduction may not exceed the amount of interest economically accrued for the period (i.e., prepaid interest is not generally deductible until accrued).[22] As one would expect, exceptions do exist, and the timing of the deduction depends on the circumstances of the transaction.

■ **Purchase or improvement**

For cash-basis taxpayers who itemize, points paid

[18]Id., at 261.
[19]H. Rep. No. 100-391, 100th Cong., 1st Sess. 1277 (1987).
[20]Temp. Regs. Sec. 1.163-10T(p)(5).
[21]Sec. 461(a).
[22]Sec. 461(g)(1).

when purchasing a home may be deducted in full in the year in which they are paid.[23] This is an important exception to the general rule on the timing of interest deductions and provides some opportunities for tax planning. Sec. 461(g)(2), however, sets out four criteria that must be met before a deduction for points will be allowed in the year paid.

☐ The points must be paid in connection with a loan obtained to purchase or improve the taxpayer's principal residence.

☐ The indebtedness must be secured by the residence.

☐ The payment of points must reflect an established business practice in the area in which the loan is made.

☐ The amount of the points may not exceed that which is generally charged in the area.

If all four criteria are met, the points may be claimed as an interest deduction in the year in which actually paid.

Points associated with indebtedness to purchase or substantially improve a taxpayer's principal residence must be actually paid by the borrower from his separate funds to qualify as a current year interest deduction. In *Schubel,*[24] the court held that amounts withheld as points from the proceeds of a loan do not fall within the Sec. 461(g)(2) special provision. Considering a discounted loan, the court stated that because the taxpayer "... received, or had available, only the face amount of the loan less the 'prepaid finance charges', those 'prepaid finance charges' were not 'paid' during [the current year]."[25] The court also pointed out that, although Congress was aware that there often is little difference in the economic substance of a transaction in which points are actually paid by the borrower and one in which the points are deducted from the proceeds of the loan, the congressional intent of Sec. 461(g)(2) was not to change the tax treatment of discounted loans.

The following examples illustrate the fact that when points are deducted from the loan amount or paid from the proceeds of the loan, they are not deductible in full in the current year, but rather must be allocated over the term of the loan.

Example 2: Taxpayer *A* purchases a primary residence and, at the time of purchase, obtains a $70,000 mortgage on the home. The lender charges points of 2% (i.e., $1,400), which *A* pays from separate funds. The $1,400 paid in points may be deducted in the year the amount is paid.

Example 3: The facts are the same as in Example 2, except that *A* instructs the lender to withhold the 2% interest points from the loan amount. Since *A* does not pay the discount points from his separate funds, a deduction for the full amount of the points is not allowed in the year of the transaction. The points may be deducted only over the term of the loan. If the term of the loan is 20 years, then *A* would deduct $70 per year ($1,400 ÷ 20 years).

The Sec. 461(g)(2) exception, allowing points to be deductible in the year paid, is restricted to the taxpayer's principal residence. It does not extend to the purchase of a second home. As previously noted, however, Sec. 163(h) does allow a taxpayer to deduct interest paid on a second residence. Consequently, points paid in connection with the purchase of a second home are not lost, but rather must be deducted ratably over the term of the loan. Needless to say, there is no provision in the Code that permits the deduction of interest and/or points associated with a third residence; they are personal interest subject to the limitations in Sec. 163(h)(6).

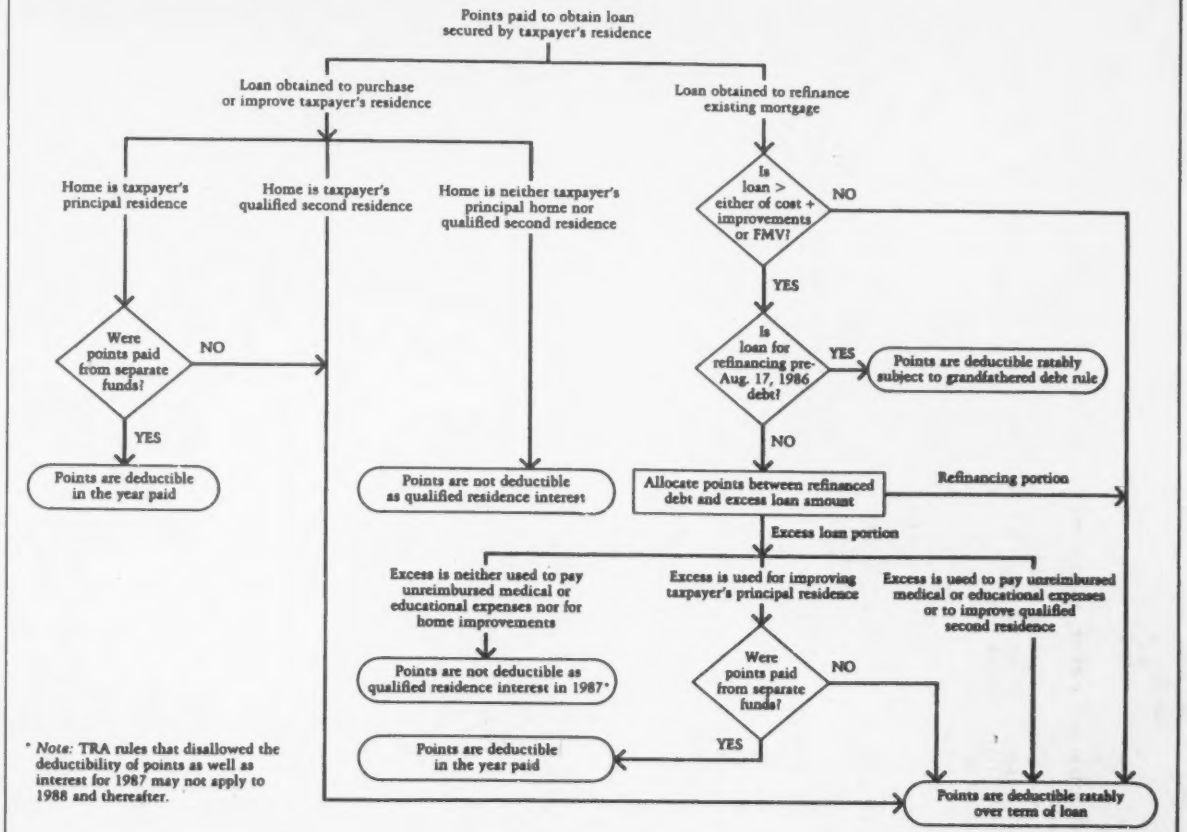
■ **Refinancing**

One area of concern to taxpayers and their advisers is the deductibility of points when a principal residence is refinanced. The Service has taken the position that points associated with obtaining a refinancing instrument is interest associated with existing debt and not related to the purchase or improvement of the taxpayer's home.[26] Therefore, such points must be deducted ratably over the term of the loan.

The 1986 Act placed a number of limitations on the deductibility of interest associated with a home refinancing loan. Under the 1986 Act, interest paid in connection with a loan to refinance a taxpayer's principal residence or one second home was generally tax deductible only to the extent that the amount of the loan did not exceed the lesser of the fair market value (FMV) of the residence or the purchase price of the residence plus the cost of any improvements.[27] A deduction for interest associated with any excess would generally not have been allowed. As a result of the latest legislation, however, the loss of this interest

[23] Sec. 461(g)(2).
[24] *Roger A. Schubel,* 77 TC 701 (1981).
[25] Id., at 704.
[26] IR 86-68 (5/13/86).
[27] Sec. 163(h)(3)(B), before amendment by the Revenue Act of 1987.

Flowchart I: Deductibility of Points in 1987


Points paid to obtain loan secured by taxpayer's residence
Loan obtained to purchase or improve taxpayer's residence
Loan obtained to refinance existing mortgage
Home is taxpayer's principal residence
Home is taxpayer's qualified second residence
Home is neither taxpayer's principal home nor qualified second residence
Is loan > either of cost + improvements or FMV?
NO
YES
Were points paid from separate funds?
NO
YES
Points are deductible in the year paid
Points are not deductible as qualified residence interest
Is loan for refinancing pre-Aug. 17, 1986 debt?
YES
Points are deductible ratably subject to grandfathered debt rule
NO
Allocate points between refinanced debt and excess loan amount
Refinancing portion
Excess loan portion
Excess is neither used to pay unreimbursed medical or educational expenses nor for home improvements
Excess is used for improving taxpayer's principal residence
Excess is used to pay unreimbursed medical or educational expenses or to improve qualified second residence
Points are not deductible as qualified residence interest in 1987*
Were points paid from separate funds?
NO
YES
Points are deductible in the year paid
Points are deductible ratably over term of loan

* *Note:* TRA rules that disallowed the deductibility of points as well as interest for 1987 may not apply to 1988 and thereafter.

deduction on the excess may be limited to 1987 only.

As previously mentioned, the Revenue Act of 1987 is applicable for tax years 1988 and thereafter. The Act retains the TRA limitations for home equity indebtedness and introduces other, more favorable, limitations for acquisition indebtedness. Indebtedness that was incurred on or before Oct. 13, 1987, and secured by a qualified residence on such date and at all times thereafter, is classified as acquisition indebtedness. Such debt is not subject to the new acquisition indebtedness limitation in 1988 and thereafter.[28] Therefore, interest associated with indebtedness incurred on or before Oct. 13, 1987 that exceeds the limitations under the TRA will not exceed the limitations under the 1987 Act. The related interest will be viewed as qualified residence interest for 1988 and thereafter.[29]

Under the latest rules, the aggregate amount treated as acquisition indebtedness for any period cannot exceed $1 million ($500,000 in the case of a married individual filing a separate return).[30] Also, refinancing of indebtedness after Oct. 13, 1987 is considered acquisition indebtedness but only to the extent of the refinanced indebtedness.[31] In other words, taxpayers who draw down the equity in their residences through indebtedness may or may not be allowed a deduction on the associated interest. If a qualified residence is refinanced for more than the existing indebtedness, the excess amount may qualify in total, in part or not at all as home equity indebtedness. Sec. 163(h)(3)(C) defines home equity indebtedness as any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent that the aggregate amount for any period does not exceed the lesser of (1) $100,000 ($50,000 for married filing separate) or (2) the FMV of such qualified residence less the amount of acquisition indebtedness with respect to the residence.

The following examples illustrate these points for 1987 under the TRA and for 1988 under the Revenue Act.

Example 4: Taxpayer *B* refinanced a mortgage secured by his principal residence. *B* originally paid $60,000 for the home and added improvements costing $10,000. The FMV of the home at the time of refinancing was $70,000 and the unpaid balance on the mortgage was $54,000. Before Oct. 14, 1987, *B* obtains a 10% refinancing loan in the amount of $70,000 and pays 2% in points (i.e., $1,400). Since the amount of the new loan is not greater than the lesser of the FMV of the residence or the cost of the residence plus improvements, all interest associated with the loan including points would be deductible as interest under the rules applicable to 1987. The $1,400 paid in interest points is deductible ratably over the term of the loan as interest expense. In 1988, all interest associated with this loan, including a ratable portion of the points, is deductible because the 1987 Act classifies the entire refinanced amount as acquisition indebtedness.

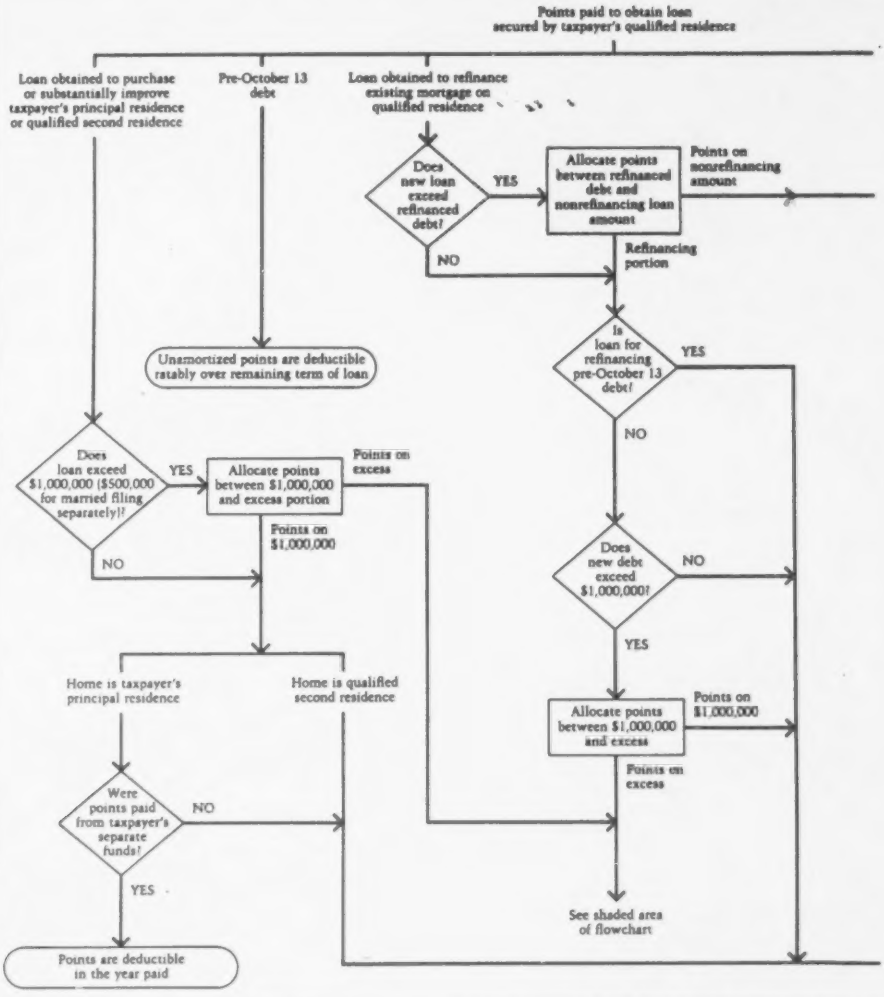
Example 5: The facts are the same as in Example 4, except that *B* obtains a refinancing loan of $71,429 and instructs the lender to withhold the 2% interest points ($1,429) from the loan amount. Since the principal loan amount is greater than the cost of the residence plus improvements (i.e., $70,000), only that portion of the interest associated with the $70,000 is considered interest paid on a qualified residence in 1987. Also, the ratable part of only $1,400 ($70,000 × 0.02) in interest points is deductible in 1987. No deduction may be taken for a ratable part of the remaining $29 associated with the excess amount of the loan over the cost of the residence plus improvements. In 1988, however, all interest associated with this loan, including a ratable portion of the unamortized $29 in points, is deductible. As in Example 4, the Revenue Act classifies the entire pre-Oct. 14, 1987 amount as acquisition indebtedness that is not subject to the "FMV or cost plus improvements" limitation.

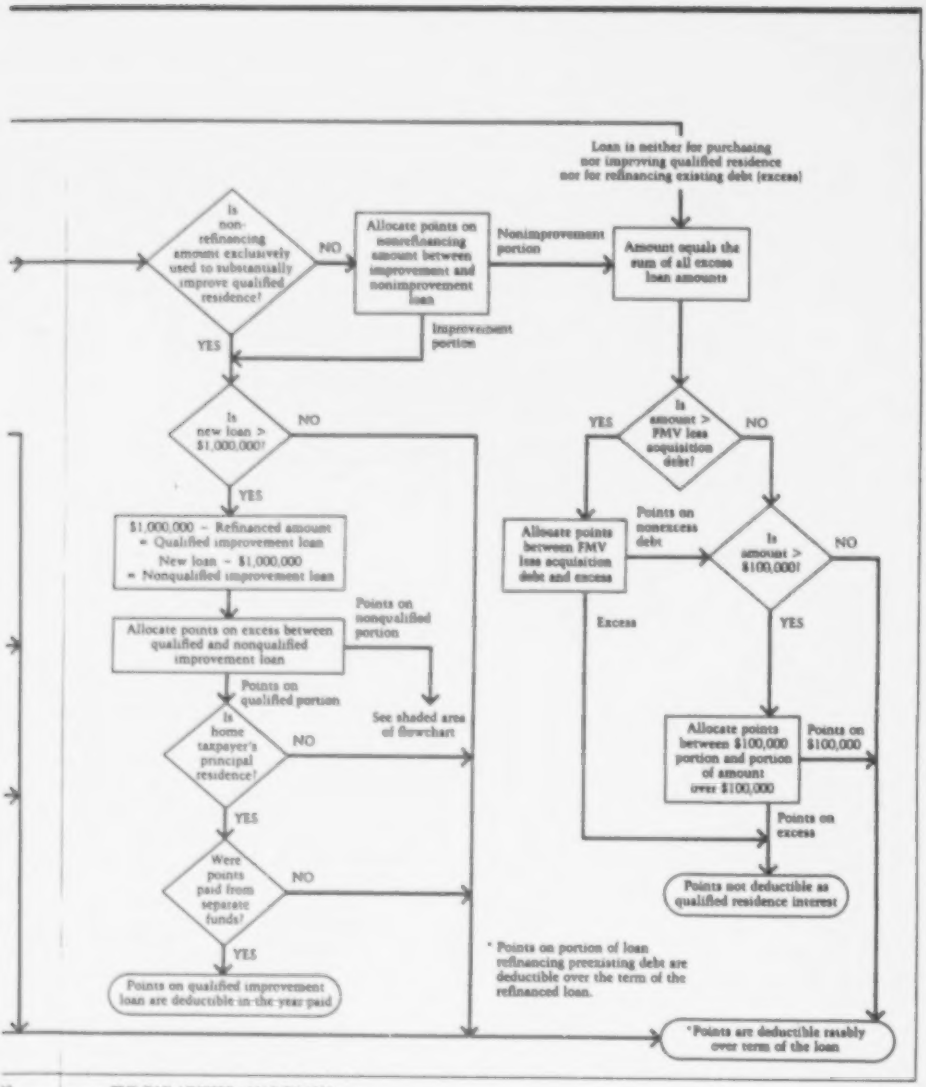
Example 6: The facts are the same as in Example 4, except the FMV of the home at the time of refinancing was $90,000. *B* obtains a refinancing loan of $80,000 on the home and pays 2% interest points ($1,600). The loan amount is greater than the cost of the residence plus improvements (i.e., $70,000), and only the interest and points associated with $70,000 of the loan would be tax deductible interest in 1987. Thus, as in Example 5, only the ratable part of $1,400 ($70,000 × 0.02) of the points would be deductible in 1987. The interest amounts associated with the $10,000 excess would not be considered interest on a mortgage associated with a qualified residence for tax purposes, and the ratable part of $200 ($1,600 − $1,400) of the points would not be allowed as a tax deduction for the principal residence. In 1988, the outstanding indebtedness would be classified as acquisition indebtedness. All interest associated with the remaining $90,000 loan, including a ratable portion of all unamortized points, would be deductible for the year 1988.

Example 7: Taxpayer *C* refinances a mortgage secured by his principal residence. In 1985, *C* originally paid $150,000 for the home and no improvements were made. The FMV of the home at the time of refinancing was $270,000 and the unpaid balance on the mortgage was $130,000. In 1988, *C* obtains a refinancing loan in the amount of $210,000.

[28] Sec. 163(h)(3)(D)(i).
[29] A letter on this point from Tony M. Edwards to Reed Shuldiner of the Office of Tax Legislative Counsel (12/30/87) appeared in *Highlights & Documents* (Tax Analysts, 1/5/88).
[30] Sec. 163(h)(3)(B)(ii).
[31] Sec. 163(h)(3)(B)(i) and (D)(iii)(II).

Flowchart II: Deductibility of Points in 1988 and Thereafter


Points paid to obtain loan secured by taxpayer's qualified residence
Loan obtained to purchase or substantially improve taxpayer's principal residence or qualified second residence
Pre-October 13 debt
Loan obtained to refinance existing mortgage on qualified residence
Does new loan exceed refinanced debt?
YES
Allocate points between refinanced debt and nonrefinancing loan amount
Points on nonrefinancing amount
NO
Refinancing portion
Is loan for refinancing pre-October 13 debt?
YES
NO
Unamortized points are deductible ratably over remaining term of loan
Does loan exceed $1,000,000 ($500,000 for married filing separately)?
YES
Allocate points between $1,000,000 and excess portion
Points on excess
Points on $1,000,000
NO
Does new debt exceed $1,000,000?
NO
YES
Home is taxpayer's principal residence
Home is qualified second residence
Allocate points between $1,000,000 and excess
Points on $1,000,000
Points on excess
Were points paid from taxpayer's separate funds?
NO
YES
See shaded area of flowchart
Points are deductible in the year paid


Loan is neither for purchasing nor improving qualified residence nor for refinancing existing debt (excess)
Is non-refinancing amount exclusively used to substantially improve qualified residence?
NO
Allocate points on nonrefinancing amount between improvement and nonimprovement loan
Nonimprovement portion
Amount equals the sum of all excess loan amounts
Improvement portion
YES
Is new loan > $1,000,000?
NO
YES
Is amount > FMV less acquisition debt?
YES
NO
$1,000,000 − Refinanced amount = Qualified improvement loan
New loan − $1,000,000 = Nonqualified improvement loan
Allocate points between FMV less acquisition debt and excess
Points on nonexcess debt
Is amount > $100,000?
NO
Points on nonqualified portion
Allocate points on excess between qualified and nonqualified improvement loan
Excess
YES
Points on qualified portion
See shaded area of flowchart
Allocate points between $100,000 portion and portion of amount over $100,000
Points on $100,000
Is home taxpayer's principal residence?
NO
Points on excess
YES
Were points paid from separate funds?
NO
Points not deductible as qualified residence interest
YES
* Points on portion of loan refinancing preexisting debt are deductible over the term of the refinanced loan.
Points on qualified improvement loan are deductible in the year paid
*Points are deductible ratably over term of the loan

Since the refinancing was completed in 1988, the rules of the Revenue Act are applicable. First, $130,000 of the $210,000 debt is classified as acquisition indebtedness (i.e., the amount of debt refinanced). Second, the remaining $80,000 ($210,000 − $130,000) is classified as home equity indebtedness because it does not exceed the lesser of $100,000 or $140,000 ($270,000 (FMV) − $130,000 (acquisition indebtedness)).

Example 8: The facts are the same as in Example 7, except that the FMV of the home at the time of refinancing was $200,000. *C* would classify $130,000 of the $210,000 refinancing debt as acquisition indebtedness (i.e., the amount of debt refinanced), and $70,000 as home equity indebtedness. The $70,000 represents the lesser of $100,000 or FMV less acquisition indebtedness ($200,000 − $130,000). The remaining $10,000 of refinancing debt would be classified as personal interest.

When secured debt exceeds the adjusted purchase price, Temp. Regs. Sec. 1.163-10T(d) sets out a simplified method for computing the qualified interest for the tax year, and Temp. Regs. Sec. 1.163-10T(e) sets out an exact method. The selection of either method is done by completing Form 8598.[32] Moreover, a taxpayer has the flexibility to use one of the methods on the first residence and the other method on the second residence. The temporary regulations also indicate that the selection of a method is not binding on a residence in future years. Of course, the temporary regulations were issued in response to the TRA. Their applicability in 1988 with respect to the Revenue Act is unclear as yet.[33]

Another noteworthy issue concerns interest associated with excess secured debt. Under the 1986 and 1987 Tax Acts, the excess amount is partially deductible as personal interest for the years 1987 through 1990. The percentage of nonqualified residence interest that may be deducted as personal interest during these years is determined under Sec. 163(h)(6) as follows:

Tax years beginning in	Personal interest deduction
1987	65%
1988	40
1989	20
1990	10
After 1990	0

Congress provided three important exceptions to the disallowance of deductions for interest on excess indebtedness secured by a principal residence or second home. The first exception, added by the TRA, is qualified indebtedness. If the excess amount of financing is used for certain educational expenses or unreimbursed medical expenses, the otherwise disallowed interest is still deductible.[34] Consequently, in Example 6, if at least $10,000 ($80,000 − $70,000) was used for educational expenses or to pay medical expenses not reimbursed by insurance, the entire amount of interest, including the ratable part of points, would be tax deductible interest in 1987.

Under the second exception, points associated with any portion of the refinancing indebtedness that is used for improvements to the qualified residence are deductible in the year paid.[35] The following example illustrates this point.

Example 9: Taxpayer *D* refinances a home mortgage with an unpaid balance of $40,000 with a new mortgage of $60,000. The home initially cost *D* $50,000. The new loan amount is not greater than the cost plus improvements or FMV of the home. *D* uses $40,000 for extinguishing the old indebtedness, $10,000 for personal use and the remaining $10,000 for making improvements to the residence. Three percentage points in the amount of $1,800 ($60,000 × 0.03) are paid in connection with the new loan. A current deduction of $300 (($10,000 ÷ $60,000) × $1,800) would be allowed for that portion of the points associated with making improvements. The balance of the prepaid interest (i.e., $1,500 ($1,800 − $300)) would be deducted ratably over the term of the loan regardless of whether the refinancing occurred in 1987 or 1988.

The final exception applies to the transfer of a qualified residence incident to a legal separation or divorce. Under Sec. 1041, no gain or loss is recognized on the transfer of property incident to a legal separation or divorce, and the transferee's basis in the property is equal to the transferor's basis immediately before the transfer occurs. This rule applies even if the taxpayer purchases the spouse's or former spouse's interest in appreciated property at its fair market value. Absent an exception to the contrary, if the taxpayer obtains a mortgage to purchase the spouse's interest, the taxpayer's basis may be less than the loan amount. Consequently, the interest would not be considered qualified residence interest.

[32] Temp. Regs. Sec. 1.163-10T(g).

[33] These two methods are not discussed in depth due to the uncertainty of their applicability after 1987 as a result of the Revenue Act of 1987. They are, however, discussed and illustrated in the temporary regulation.

[34] Sec. 163(h)(4), before amendment by the 1987 Act. Revenue Act Section 10102(b) repeals Sec. 163(h)(4), effective Dec. 31, 1987.

[35] Sec. 461(g)(2).

If the Technical Corrections Bill of 1987[36] had passed, it would have provided relief from this unintended result by amending Sec. 163(h)(5)[37] to include a provision allowing the transferee taxpayer an increase in the amount of qualified residence interest up to the lesser of the amount of debt incurred to purchase the spouse's interest, or the FMV of the interest purchased. This provision would have allowed interest paid on debt incurred to acquire the spouse's interest in appreciated property to meet the requirements of qualified residence interest, as is illustrated in the following example.

Example 10: *H* and *W* owned a home with a basis of $60,000 and an FMV of $100,000. A $50,000 mortgage was secured by the residence. After a divorce, *H* and *W* own a one-half interest each in the residence, i.e., each has a basis of $30,000. *W* obtains a refinancing mortgage of $75,000 and pays three percentage points in the amount of $2,250 ($75,000 × 0.03). The previously existing debt is extinguished with $50,000 and the remaining $25,000 is used to purchase *H*'s interest in the residence. After the transfer, the basis in the property to *W* is $60,000 (i.e., her original basis of $30,000 increased by the carryover basis from *H* of $30,000). In 1987, interest on the full $75,000 mortgage is deductible as qualified residence interest since the debt does not exceed *W*'s original basis plus the FMV of *H*'s interest in the property. In 1988, the debt is reclassified as acquisition indebtedness and the interest on the entire principal balance is deductible as qualified residence interest.

At present, the statutes do not specify the timing of the deductions for points paid in connection with the purchase of a former spouse's interest in a residence incident to a divorce. Sec. 1041(b)(1) specifies that property transferred incident to divorce must "be treated as acquired by the transferee by gift. . . ." Points are deductible in the year paid only when debt is incurred for purchasing or improving a principal residence. Therefore, the requirement that property transferred incident to a divorce must be treated as a gift may preclude deduction of the points in the year paid and, instead, require that they be deductible ratably over the term of the loan. Logically, however, points associated with that portion of the mortgage required to obtain the interest of the spouse or former spouse in a principal residence would presumably be deductible when paid. The points associated with that portion of the mortgage used to refinance the taxpayer's share of the original mortgage would presumably be deductible ratably over the term of the loan.

The final area of consideration for refinancing relates to the refinancing of grandfathered debt. Sec. 163(h)(3)(C), before amendment by the Revenue Act of 1987, allowed home mortgages in excess of basis obtained before Aug. 17, 1986 to be classified as qualified residence interest even if the excess indebtedness was not used for medical or educational purposes, or for home improvements. Since such debt would also be pre-Oct. 13, 1987 debt, points paid to refinance the debt would be fully deductible up to that amount of prepaid interest associated with the balance of the refinanced indebtedness immediately before the refinancing.

■ **Early repayment**

It is not uncommon for taxpayers to sell their homes before the related indebtedness is fully extinguished.[38] If the loan is not assumed by the purchaser, then the principal balance is due from the seller on closing the sale. Since the principal balance is due at closing, any related interest would also be due at that time. Rev. Proc. 87-15[39] dictates the method to be used for allocating points over the term of the loan. It appears that the Service allows an interest deduction in the year of sale for any unamortized points.

When a homeowner sells his residence and the existing debt is assumed by the purchaser, the debt is not extinguished; instead, it passes to the buyer. In a technical sense, the seller is contingently liable in case of default by the purchaser. A question arises from this form of transaction. How does the seller treat any unamortized interest points? Four alternatives are possible.

☐ The interest deductions for any unamortized prepaid interest attach to the mortgage.

☐ The unamortized points are added to the cost of the property.

☐ The original mortgagor continues to deduct the unamortized points over the remaining term of the debt contract, or until the debt is repaid.

[36]Technical Corrections Bill of 1987, HR 2636, 100th Cong., 1st Sess. (1987). As of this writing, the bill has not been approved by Congress.

[37]Paragraph (5) has been redesignated as paragraph (4) by Revenue Act Section 10102(b).

[38]Similarly, a person may refinance the indebtedness more than once.

[39]Rev. Proc. 87-15, IRB 1987-14, 47. The details of this revenue procedure are given in the appendix on page 216.

☐ The assumption is treated as a debt extinguishment.

Treating the assumption as a debt extinguishment appears to be the appropriate response according to the decision in *S. & L. Building Corp.*[40] In that case, the IRS contended that the unamortized mortgage fees should be added to the basis of the property sold. The Board of Tax Appeals disagreed with the Service and held instead that "[m]ortgage fees paid to secure loans . . . do not represent cost of property, but represent cost of the use of money borrowed."[41] Moreover, the Board held that an expense deduction should be allowed for the entire amount of unamortized loan fees in the year that the property was sold and the mortgage assumed by the buyer. The court stated: "He, having shifted the burden of his mortgage to other shoulders, stands in the same situation as if he had paid it off and therefore should be allowed to deduct the remaining portion of his unamortized mortgage fees."[42] Thus, it would appear that taxpayers are permitted to claim a current year tax deduction for the balance of unamortized points when selling a qualified residence.

Homeowners may also retire their mortgage debt before its full term by making extra payments. Many lenders allow borrowers to make extra monthly payments, to be applied toward the reduction of the principal loan balance. When this occurs, the loan is repaid more rapidly than required by the mortgage contract. Since these additional payments are not "due" in the year paid, the question arises as to when the related portions of points may be claimed as interest deductions. A literal reading of Rev. Proc. 87-15 suggests that a deduction for the amount of points associated with those extra payments would not be allowed earlier than the tax year when the extra payments are actually due. If this treatment were followed, a taxpayer could, for instance, extinguish a 30-year debt on his primary residence or second home in less than 30 years by making additional monthly payments, and still be required to continue allocating the points paid as interest for the full 30 years. This does not appear to be a reasonable allocation procedure since interest would be allocated to periods in which no indebtedness exists.

A possible solution to this problem is to consider each additional payment applied to the indebtedness as effectively shortening the term of the loan. Under this approach the allocation would be recomputed each year in which additional payments are made. For example, on a 30-year loan with $1,500 in prepaid interest points, the yearly allocation would be $50 [($1,500 ÷ 360) × 12]. If additional payments were made in the first year such that the term of the remaining balance was only 28 years, the allocation for the first year would be recomputed to be $53.57 [($1,500 ÷ 336) × 12]. A drawback to this method is that information concerning the remaining number of payments to be made may not be readily available to the taxpayer.

The more practical alternative would be to allocate the points ratably as if no additional payments had been made. In the year in which the debt is repaid, any remaining unamortized points would be deducted. This approach is consistent with the taxpayer who sells his home and pays off the indebtedness, or simply extinguishes the loan by using other funds.

Lower Interest Rate Versus Lower Points

A final question that merits attention is whether the taxpayer who is planning to refinance an existing home mortgage should select the lower interest rate/higher points or the higher interest rate/lower points mortgage option. At present, there are no reliable rules of thumb; each case must be reviewed individually. However, two factors enter into this decision: the taxpayer's ability to pay points, and the taxpayer's future intentions concerning the residence.

If paying points and obtaining a lower interest rate on the mortgage will result in a lower cost of financing, the first question that must be addressed is whether the taxpayer has the financial means to pay the points. To take advantage of the lower cost of debt, the taxpayer must have funds available for paying points or have the ability to borrow or otherwise obtain the necessary cash.

With respect to the second factor, if the individual does not plan to sell the residence or prepay the mortgage in the near future, the tax rate over the life of the loan must be considered (i.e., the points are charged ratably to income while inter-

[40] *S. & L. Building Corp.*, 19 BTA 788 (1930).
[41] Id., at 795.
[42] Id.

Appendix: Method of Allocation

Rev. Proc. 87-15 specifies the method to be used for allocating the interest deduction for interest points associated with home mortgage loans that must be allocated ratably over the term of the loan. The procedure applies to (1) mortgages on qualified residences not exceeding $250,000 or (2) points charged of not greater than 4% on 15-year loans and not greater than 6% on loans with terms longer than 15 years. The procedure for allocating points ratably over the life of the loan involves the following five steps.

1. Determine the dollar amount of points that qualify as interest charges.
2. Subtract the amount of points deductible when paid under Sec. 461(g)(2) to determine the amount to be allocated over the term of the loan.
3. Divide the total amount to be allocated found in step 2 by the total number of periodic payments to be made on the loan to determine the dollar amount of interest points associated with each periodic payment.
4. Add together the number of periodic payments due and paid in the current year, plus those due in the current year but paid in a previous year.
5. Multiply the sum found in step 4 by the dollar amount computed in step 3. This is the amount of interest deduction for the year that may be claimed in connection with the interest points.

The following example illustrates the procedure for an individual taxpayer.

Facts: A taxpayer refinances a mortgage on a qualified residence. The principal amount of the new 15-year loan is $60,000, of which $50,000 is to be used to retire the existing mortgage and the other $10,000 is for building an addition to the home. The amount of the new loan is not in excess of the cost of the home. Three percentage points are charged by the lender as additional interest, and eight periodic payments are due and paid in the current year.

Result: The following computational steps are taken to determine that a tax deduction of $366.64 is allowed in the first year for prepaid interest points.

1. Amount qualifying as interest charges:

   $1,800 [$60,000 × 0.03]

2. Total amount to be allocated ratably over term of loan:

   $1,500 [$1,800 − [$10,000 × 0.03]]

3. Dollar amount of interest points associated with each periodic payment:

   $8.33 per month [$1,500 ÷ [15 years × 12 months]]

4. Payments due and paid during current year: 8

5. Amount of deductible interest associated with allocated interest points in current year:

   $66.64 [8 × $8.33]

The $300 in interest points associated with $10,000 of the loan is deductible in the year paid. Thus, the total amount of points deductible in the first year is $366.64.

est is charged economically to income). For an individual who expects his income to decrease, the maximum tax benefits may be obtained by incurring interest in the early years of the loan when the tax rate is higher. The higher interest rate and low (or no) points mortgage option seems to fit this criterion. Alternatively, if income is expected to increase, and/or if the tax rates are expected to increase, deferring the interest (i.e., low interest rate/high points) may be the wiser choice.

For the individual who expects to sell the residence or prepay the loan, the higher interest rate and no points mortgage option should be given serious consideration. The prepayment of interest in the form of points corresponds to the use of the money over a specified period of time. When the loan is prepaid, that portion of the points that was paid to secure the use of the funds for the period of time beyond the prepayment date is not refunded. The end result is that the points paid are for the use of funds over a shorter period than originally intended, thereby increasing the effective interest rate of the mortgage.

In advising the taxpayer, the practitioner should analyze the facts in each individual situation, including the taxpayer's current status in his earning cycle, expectations concerning future tax rates, the number of years the taxpayer is likely to maintain the mortgage debt, and the effective interest rate under various combinations of interest rates and points.

Conclusion

Points may be deductible in the year paid, deductible ratably over the life of the loan, nondeductible or some combination of the three. The proper path, as shown in the flowcharts for 1987 (TRA rules) on page 208, and for 1988 (Revenue Act rules) on pages 210–211, appears easy enough as long as certain facts about the loan and the property are clearly established. The difficulty is that several unresolved issues, such as the definition of the qualified second residence, exist. Thus, the tax adviser should proceed cautiously through this area. TTA

"APPENDIX D"

ANNALS OF TAXATION

"A TAX SYSTEM OUT OF CONTROL"

Has the tax code reached a state of such confounded complexity that even tax professionals can no longer make head or tails of parts of it—can no longer depend on it in planning investments, business decisions, retirement and other tax-related moves?

When matters reach a really confused state, with complexity giving way to downright impenetrability, it is sometimes said that even a Philadelphia lawyer couldn't straighten it all out. Well, we know of a group of Philadelphia lawyers (actually, they're from Bryn Mawr, a suburb) who have reached that conclusion about the Internal Revenue Code.

Five partners in the Stephen R. Leimberg firm recently whipped off a most irate letter to members of Congress, urging that they cease and desist from further reworking of the tax laws and suggesting that the whole problem can be traced back to the Tax Reform Act of 1976.

Why don't we let the Leimberg partners state their own case, with selected portions of their letter to Congress:

"You are about to change the tax law for the *10*th time in *11* years. This rate of change exceeds the ability of even the most conscientious tax practitioner to keep up.

"You are about to take back provisions that planners and their clients have come to rely upon. There is no reliability. We can't trust that either a business contract or a personal agreement entered into today on the basis of current tax law will be subject to uniform treatment throughout its duration.

"It is not unfair to raise taxes—but it is unfair to add unnecessary but significant cost in the form of the mountainous paperwork involved in learning, unlearning, and relearning and then trying to comply with rules Einstein couldn't comprehend.

"In many cases it is impossible to comply with recent tax laws because the Treasury regulations explaining what was really meant don't appear for many years—if ever. When they are released, these regulations often arrive in the form of 50 to 80 pages of fine print that further obfuscates rather than clarifies.

"Tax law is at odds with the pronouncements of government agencies admonishing citizens to save for themselves and provide for their old age. Pity the senior citizen who depends on the private pension system. That poor soul is taxed if he or she (1) receives too much of a retirement distribution, (2) takes too little of a retirement distribution, (3) takes the retirement money too early, or (4) takes the retirement money too late. By the end of next year, many future retirees must make an important election regarding their accrued pension benefits that can cost them tens of thousands of dollars—if they make the wrong choice or if they fail to choose. For many, the year will pass without any realization that they even had a choice. For others, even the experts are confounded as to what to advise.

"Many tax law provisions have been passed so quickly and with such little deliberation and consideration as to their implication that they have to be repealed or revised almost as soon as they become effective. For instance, consider the change in the installment sales rules. The "proportionate disallowance" rule—passed in the TRA of 1986—is now called "inordinately complex" in the Senate Finance Report that seeks to revoke it. To appreciate how truly frightening this situation has become, consider the following: The regulations for the time value of money now span many hundreds of pages of text; those for special partnership allocations rules, several hundred pages; and those for net operating loss carryovers, a like amount.

"How did this out-of-control situation happen? Prior to 1976, major tax legislation had an appropriate seven-year cycle time (1954, 1962, 1969, 1976) during which time the effect of the law was monitored. The gap did not reflect inactivity by the Congress in the tax area. Rather, the time between formal changes was marked by a continuing policy-making process that proceeded with thoroughness and deliberation. As new areas of legislation were identified, extensive hearings were held. Input was received from practitioners in the field concerning not only the proposed statutory language but also how the proposal might interrelate with other statutory provisions.

"Something went wrong in this process beginning in 1976. The Tax Reform Act of 1976 contained provisions that had not been even suggested before markup. New code sections were enacted without the benefit of rigorous analytical discussion as part of a political agenda. Large portions of the 1976 tax law were unwieldy or incomprehensible. A decade of experience with a law that now had been determined to have never received regulatory guidance from the Treasury has driven the legislature, with Alice-in-Wonderland logic, to fashion an even more complex structure. Will the public be given the certainty of law under this new effort, or will this law too someday be retroactively cast off as inordinately complex after the howls of protest from practitioners and constituents?

"The time has come for you—our representatives—to take a long look at a tax system out of control."

—Arthur Lodge, editor of the AICPA's CPA Client Bulletin

87-154 (152)